UNITED STATES OF AMERICA Before The POSTAL RATE COMMISSION WASHINGTON, D.C. 20268-0001

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Postal Rate and Fee Changes, 2000

Docket No. R2000-1

INITIAL BRIEF

OF

THE OFFICE OF THE CONSUMER ADVOCATE

TED P. GERARDEN DIRECTOR

EMMETT RAND COSTICH SHELLEY S. DREIFUSS KENNETH E. RICHARDSON ATTORNEYS

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Docket No. R2000-1

INITIAL BRIEF OF THE OFFICE OF THE CONSUMER ADVOCATE

The Office of the Consumer Advocate ("OCA"), pursuant to Rule 34 of the Rules of Practice and Procedure of the Postal Rate Commission ("Commission"), 39 C.F.R. § 3001.34, and pursuant to Presiding Officer's Ruling No. R2000-1/71, hereby submits its Initial Brief on the Request of the Postal Service for a Recommended Decision on Rates and Fees for postal services.

EXECUTIVE SUMMARY

Overview. Docket No. R2000-1 presents several critical underlying issues for resolution by the Commission. These include the proper use of new information provided by the Postal Service as a result of Order No. 1294, evaluation of the Postal Service's request for a substantial increase in the contingency provision, and another effort by the Postal Service to substantially reduce the attributable costs in mail processing.

As these issues are evaluated, the OCA urges the Commission to consider carefully the interests of the American consumer. While the Postal Service portrays its proposed increase in the basic stamp rate as modest, it belies that fact that First-Class

Mail users have not reaped the full benefits of the automation programs of the past decade. As a result of the success of those programs, the cost of handling First-Class Mail, including single-piece mail, has declined—but this mailstream has been burdened with an ever-increasing cost coverage. As a result, there has been a hidden "tax" on First-Class Mail that has increased the degree to which First-Class revenues effectively support other classes of mail through the ever-larger portion of the Postal Service's institutional costs borne by First-Class Mail.

The OCA therefore urges the Commission to recommend that the basic First-Class, first-ounce rate remain at 33 cents. While this restraint will begin to redress the extra burden that First-Class Mail has been carrying in recent years, it need not force other classes of mail to pay exorbitantly high rates. The OCA urges the Commission to utilize recent actual financial results to temper the roll-forward of costs to the test year. These recent results indicate that the Postal Service's updated test year estimates are too high. Moreover, the OCA urges the Commission to recommend continuation of the existing one percent contingency provision. The Postal Service's sharp increase in its contingency request is not supportable, and would place undue burdens on all mailers. With restraint on the level of the Postal Service's test year costs and the contingency, together with recognition of certain errors (such as the revenue adjustment factors that benefit single-piece First-Class mail), the Commission can fully justify retention of the 33 cent stamp rate and still recommend only modest rate increases for other classes of mail.

The Order No. 1294 Updates. The Commission must take care that it uses only the reliable aspects of the Postal Service's Order No. 1294 updates. More recent

economic forecast indices provided by DRI, for example, should be incorporated to improve the accuracy of the test year projections. Actual FY 2000 total expense data, which will be available to the Commission as it prepares its recommended decision, should be used to restrain the Postal Service's FY 00 interim year projections. Unsupported aspects of the update's roll-forward adjustments, however, must be rejected. This includes the unsupported—and now repudiated—change from ECI-1 to ECI. Finally, the Postal Service's Breakthrough Productivity cost reductions should be accepted in full, including rejection of the \$200 million "Field Reserve."

The Contingency Provision. The Commission should recommend continuation of the present one percent contingency provision as reasonable under all of the circumstances confronting the Postal Service. The 2.5 percent contingency requested by the Postal Service is unnecessary, unsupported, and harmful to all mailers. Nothing in the Postal Service's case, including the belated efforts to portray risky uncertainty in the economy, can justify burdening consumers and mailers with these additional costs.

Volume Variability and Cost Attribution. The Commission should resist efforts by the Postal Service and other parties to reduce attributable costs. Once again, the Postal Service is trying to persuade the Commission to abandon 100 percent volume variability for key mail processing cost pools. The effect would be to shift substantial costs to the institutional category, to the detriment of those classes of mail and services (such as First-Class Mail) that are assigned high cost coverages. The Postal Service's effort suffers from the same basic flaws as it did in Docket No. R97-1, all of which are

addressed in detail in the OCA's evidence and in this Initial Brief.¹ To the contrary, and particularly with respect to mail processing and city carrier load time, the Commission should attribute costs to services in the manner that most accurately reflects the costs of providing the services.

First-Class Mail. The First-Class first-ounce rate should remain at 33 cents. Revenue should be attributed to single-piece First-Class Mail for the net overpayment of postage, and the "as-filed" method should be used to forecast additional ounces. Coupled with beneficial cost changes, retention of the 33 cent stamp rate will permit the Commission to reverse the recent trend of First-Class Mail's increasing contributions to the Postal Service's institutional costs. The record plainly demonstrates that First-Class Mail's share of the cost burden has escalated beyond the intent of the Commission, and restraint is needed now to prevent the situation from becoming even more unfair. Investment in automated letter-mail processing equipment has kept the cost of First-Class Mail down, and consumers—the primary users of single-piece mail—should receive the benefit of the Postal Service's success in this area.

In other issues relating to First-Class Mail, the Commission should recommend a rate category and corresponding discount for Courtesy Envelope Mail ("CEM") to permit the public to share in the lower cost of handling automation-compatible mailpieces. In the event that the Commission recommends a 34 cent First-Class stamp rate, the Commission should recommend that the Postal Service adopt a rate stability plan under

A complete summary of the OCA's position on volume variability of mail processing costs is found in Argument Section III.A, which provides a separate overview of this complex and hotly contested issue.

which single-piece First-Class rates change in the future in only every other rate case.² This would permit greater rate stability and convenience for consumers while accommodating large mailers' preference for smaller, more frequent and predictable rate increases. The anachronistic and poorly supported nonstandard surcharge should be eliminated for square and near-square letter mail. Finally, in the event that the Commission does recommend a 34 cent First-Class stamp rate, the Commission should also encourage the Postal Service to improve convenience for consumers by providing courtesy "make-up" stamps at the time of the rate change.

Special Services/BPRS. The Commission should recommend a reduction, not an increase, in the fees for domestic and military money orders. With respect to insurance, the proposed rate increase for unnumbered insurance should be scaled back, and the Commission should reject the unsupported increase in the per increment fee for insurance. The Commission also should encourage the Postal Service to make electronic money orders and electronic delivery confirmation available to individuals through its website. With respect to bulk parcel return service, the Commission should reject the proposed reduced rate and, instead, set the rate based on close to system-wide average cost coverage.

If the existing 33 cent First-Class stamp rate is recommended, the Commission will effectively provide the desired rate stability for single-piece mail in this case.

STATEMENT OF THE CASE

On January 12, 2000, the United States Postal Service filed, pursuant to Sections 3622 and 3623 of the Postal Reorganization Act (39 U.S.C. §§ 3622 and 3623), its Request with the Postal Rate Commission for a recommended decision on proposed changes in domestic rates and fees for all classes of mail and all special services ("Request"). The Request was accompanied by 41 pieces of testimony sponsored by 40 witnesses. Most of the testimony was supported with exhibits, workpapers and extensive library references.

The Request maintained that "[w]ithout rate and fee changes, the Postal Service would incur a substantial revenue deficiency in the proposed test year" (FY 2001) of more than \$3.6 billion, in contravention of 39 USC § 3621.³ With the proposed rates and fees, sufficient revenue would be generated to produce an estimated revenue deficiency of approximately \$21.8 million.

Under the Postal Service's Request, the price of a First-Class stamp would be increased by one cent, from 33 cents to 34 cents for letter mail. The additional-ounce rate would increase one cent from 22 to 23 cents. Single-piece cards would increase from 20 to 21 cents.

Rate increases for Periodicals would average 8.5 percent for Within County and 12.7 percent for Outside County. In Standard Mail (A), rate increases would average 9.4 percent, 4.9 percent for Regular and Enhanced Carrier Route, and 5.6 percent and

³ "Request of the United States Postal Service for a Recommended Decision on Changes in Rates of Postage and Fees for Postal Services," January 12, 2000 at 1.

14.8 percent for nonprofit and nonprofit ECR. Standard Mail (B) rate increases would average 1.3 percent for parcel post, and 18.1 percent for Bound Printed Matter, 4.9 percent for Special, and 4.5 percent for Library.

Classification changes for First-Class Mail would separate the combined 3/5 digit category for flats into discrete 3- and 5-digit tiers. As for Periodicals, three of the four current subclasses would be combined in one subclass to be referred to as "Outside County." Standard Mail parcels within what is generally referred to as Standard (A) mail (Regular, ECR, Nonprofit and Nonprofit ECR), would receive a parcel barcode discount. Special services would be extended to parcels for: delivery confirmation, return receipt for merchandise, and bulk insurance service. Standard (B) would be renamed as Package Services, Special Standard renamed as Media Mail, and destination-entered parcel post renamed as Parcel Select. Parcel Post intra- and inter-Bulk Mail Center ("BMC") would continue to be called Parcel Post. The Service also proposes allowing pieces weighing less than one pound in all Standard Mail subclasses, and eliminating local rates and adding destination drop shipping discounts for Bound Printed Matter. New nonmachinable surcharges would apply to Parcel Select-DBMC and intra-BMC parcels.

In addition to a general rewrite of the DMCS sections on special services, the Service proposes a major restructuring of the fee structure for post office boxes, elimination of the merchandise return service fee, and extension of several special services to Standard Mail (A) parcels. A quarterly fee option would be added for users of Qualified Business Reply Mail ("QBRM").

By Order No. 1279, issued January 14, 2000, the Commission set the Postal Service's Request for hearing as Docket No. R2000-1 and designated the OCA to represent the interests of the general public.⁴ Seventy-nine parties intervened in the case.

Prior to the hearings on the Postal Service's direct case, the Commission issued Order No. 1289 requiring the Postal Service to present detailed evidence explaining the causes of the trend in the costs of processing Periodicals from a witness qualified to respond to participants' questions on the topic.⁵ The Commission sat *en banc* for evidentiary hearings on the Postal Services' direct case from April 11, 2000 until May 11, 2000.

Subsequently, Commission Order No. 1294 announced the Commission's intention to use actual Postal Service FY 1999 CRA cost data in test year forecasts to the extent feasible, consistent with providing due process.⁶ The Commission Order also provided that, "The Postal Service may incorporate with this information such other updates as it believes will more accurately forecast test year results." Pursuant to that Order, the Presiding Officer permitted the Postal Service "to develop additional adjustments to its test year projections, for example, to incorporate more recent inflation

⁴ "Notice of the United States Postal Service's Filing of Proposed Postal Rate, Fee and Classification Changes and Order Instituting Proceedings," PRC Order No. 1279, January 14, 2000, at 8.

⁵ "Order Requesting the Submission of Evidence on Periodicals Processing Costs," March 28, 2000.

⁶ "Order on the Use of FY 1999 Data," May 26, 2000.

⁷ Id. at Ordering ¶3.

forecasts or programs estimates" and extended parts of the procedural schedule.⁸ The Postal Service filings of July 7 in response to Order No. 1294 included several significant cost increase adjustments and reflected a test year after rates deficiency of \$275.3 million. Patelunas, USPS-ST-44 at 9.

Hearings on the cases-in-chief of intervenors and participants were held from July 6 to 21, 2000, and hearings on the Postal Service's revision to the test year forecasts were held August 3-4, 2000. The OCA's direct case consisted of the testimony of witnesses Gerarden (OCA-T-1), Burns (OCA-T-2), Rosenberg (OCA-T-3), Smith (OCA-T-4), Ewen (OCA-T-5), Callow (OCA-T-6), Willette (OCA-T-7), Collins (OCA-T-8), and Thompson (OCA-T-9).

Further rebuttal testimony was filed by the OCA by witnesses Callow (OCA-RT-1), Rosenberg (OCA-RT-2), and Thompson (OCA-RT-3). Additional testimony from several participants was prompted in response to Notice of Inquiry (NOI) No. 4 relating to the volume variability of mail processing costs. OCA witness Smith filed testimony (OCA-RT-4) in response to several questions from the Commission in NOI No. 4 and examination of that testimony was conducted at the end of the rebuttal cases.

Hearings on the rebuttal evidence to participants' direct evidence and changes to the cases-in-chief to reflect the Postal Service's updated cost information were held August 22 to August 31, 2000. A total of 49 separate transcript volumes have been issued in this proceeding.

⁸ "Presiding Officer Ruling Revising the Procedural Schedule to Accommodate Actual FY 1999 CRA Cost Data," May 26, 2000, Ruling No. R2000-1/71 at 1.

STATEMENT OF POSITION OF THE OFFICE OF THE CONSUMER ADVOCATE

Pursuant to Rule 34(b)(3), the OCA hereby provides a brief statement of its position as to the principal proposals of the Postal Service addressed by the OCA. The OCA's views are also summarized in the Executive Summary, *supra*, and addressed in detail in the body of this Initial Brief. The OCA reserves the right to take further positions in its Reply Brief to be filed September 22, 2000.

The OCA *opposes* the Postal Service's overstated revenue request. By using more recent forecasts of economic indices and by incorporating FY 00 actual results, the Commission can with confidence recommend a more modest test year revenue requirement than that suggested by the Postal Service in the Order No. 1294 update filing. The OCA *opposes* the use of ECI and urges the Commission to continue to apply ECI-1 in calculating test year costs. The OCA *supports* the Postal Service's cost reduction forecasts for Breakthrough Productivity but *opposes* the \$200 million "Field Reserve." The OCA *opposes* unsupported and judgmental changes in the update roll-forward process and *opposes* the Postal Service's revised workyear mix adjustment.

The OCA opposes the Postal Service's request to increase the contingency provision to 2.5 percent. The Postal Service has not supported this substantial contingency request with credible and substantial evidence. Contrary to the Postal Service's claims, the evidence shows that economic conditions are favorable to maintaining the existing one percent contingency.

The OCA opposes the Postal Service's effort to reduce the volume variability of certain mail processing cost pools below 100 percent. The second iteration of the

Postal Service's attack on mail processing cost attribution contains many of the same flaws as were noted in Docket No. R97-1. The OCA urges the Commission to continue to apply the existing 100 percent volume variability to these cost pools.

The OCA *supports* the Postal Service proposal to use the new Engineered Standards study of city carrier street time rather than the 1986 STS study, but *opposes* the Postal Service's use of the "stops effect" and the attempt to draw regressions from the Engineered Standards data for purposes of estimating elemental load time. The OCA urges the Commission to attribute city carrier load time costs as it did in Docket No. R97-1.

The OCA opposes the Postal Service's proposal to raise the First-Class stamp rate to 34 cents. The existing 33 cent rate should be maintained in light of the declining costs of handling letter mail and the increasing institutional cost burden that has been placed on First-Class Mail over the past several years. The OCA also opposes the Postal Service's belated effort to change the filed methodology for determining additional ounces, and urges that the benefit of revenue adjustment factors for net overpayment of postage be directed primarily to single-piece First-Class Mail. The OCA also urges adoption of a discount for single-piece automation-compatible courtesy envelope mailpieces. The OCA opposes continuation of the anachronistic nonstandard surcharge for low aspect ratio letters.

The OCA urges that the Postal Service adopt a strategy to provide greater rate stability for single-piece First-Class mail by changing the rate in every other rate case. When stamp rates do change, the OCA urges the Postal Service to provide courtesy make-up stamps to the public to ease the transition to new postal rates.

The OCA *opposes* the Postal Service's proposal to raise rates for domestic and military money orders and for insurance. To the contrary, the OCA urges the Commission to recommend a reduction in the money order fees, and to reduce or eliminate the increases proposed for insurance.

The OCA opposes the Postal Service's reduction in the rate for Bulk Parcel Return Service. This service has a high value, and should have a rate based on a cost coverage close to the system average cost coverage.

BURDEN OF PROOF

Under the Postal Reorganization Act, it is the Postal Service that initiates a request to change its rates and fees. In all matters relating to the rates and fees requested, the Postal Service is the moving party and must justify the requested rates. The Administrative Procedure Act makes clear that "[e]xcept as statutes otherwise provide, the proponent of a rule or order shall have the burden of proof."

The burden of proof establishes specific requirements for the Postal Service's evidence and the criteria against which that evidence is to be measured. As explained

⁹ 39 U.S.C. § 3622(a) provides that "[f]rom time to time the Postal Service shall request the Postal Rate Commission to submit a recommended decision on changes in a rate or rates of postage or in a fee or fees for postal services if the Postal Service determines that such changes would be in the public interest and in accordance with the policies of this title. The Postal Service may submit such suggestions for rate adjustments as it deems suitable."

As the Supreme Court explained in the context of the Natural Gas Act, a regulated entity "initiating an increase in rates . . . assumes the hazards involved in that procedure. It bears the burden of establishing its rate schedule as being 'just and reasonable.'" *FPC v. Tennessee Gas Pipeline Company*, 371 U.S. 145, 152 (1962). Similarly, the Postal Service bears the burden of establishing that its proposed rates and fees are "reasonable and equitable." 39 U.S.C. § 3621.

in 4 Stein, Mitchell, Mezines, Administrative Law § 24.01 at 24-5 through 24-9 (1991, emphasis added):

The term "burden of proof" often contemplates what the litigating proponent must establish in order to persuade the trier of the facts of the validity of his claim or affirmative defense and, at time, is referred to as the "burden of persuasion" . . . [I]t is a burden derived from substantive law which becomes an active factor in the context of litigation when all of the evidence has been submitted

It is imperative to note that the burden of proof remains fixed throughout the litigation on the proponent, who must sustain his burden of persuasion in a qualitative manner, specifically with credible evidence.¹¹

The burden of proof (or persuasion) is to be distinguished from the burden of going forward, which is simply the burden of advancing one's position, either initially or in response to evidence by other parties. The difference is that the burden of proof is always fixed upon the proponent of a change, while the burden of going forward may shift repeatedly through the course of the litigation.

In this case, the Postal Service has failed to sustain its burden of providing qualitative and credible evidence on a number of issues relating to the changed rates and fees that it seeks. As will be discussed in the argument that follows, this is especially true for critical matters pertaining to the proposed revenue requirement—the contingency provision and several aspects of the increased costs in the Order No. 1294 update.

The OCA recognizes that the burden of proof also applies to those who propose a change where the Postal Service does not. In such cases, the proponent of change

See also McCormick on Evidence (4th Ed. 1992) at 427.

similarly bears the burden of supporting the change through qualitative and credible evidence. In respect of the changes that it proposes, the OCA has met its burden.

ARGUMENT

I. SELECTIVE USE SHOULD BE MADE OF FY 1999 ACTUAL DATA AND ORDER NO. 1294 UPDATES

Order No. 1294 required the Postal Service to provide actual data from FY 99. The OCA concurs that FY 99 data, to the extent it is supported in the record, should be used as the base year for roll-forward purposes. Several aspects of the update and roll-forward, however, must be closely examined to determine whether certain of the new costs may be used.

A. The Commission Should Use the Most Recent Economic Forecast Indices

There appears to be no real disagreement among the participants that the most recent economic forecast indices should be used to estimate test year costs. Indeed, in summarizing comments received in response to Notice of Inquiry No. 1 Concerning Base Year Data, the Commission noted (with respect to the use of FY 1999 data) that "[t]he consensus of opinion was that use of more recent data is generally preferable."

Although the Postal Service prefers that the Commission base any rate increases on its original filing, 12 which consists of a roll-forward from base year FY

In response to interrogatory OCA/USPS-ST44-8 (redirected from witness Patelunas to the Postal Service), the Postal Service states:

The Postal Service has complied with the Postal Rate Commission's orders to update the cost roll-forward model to reflect the FY 1999 actual costs, particularly as they relate to (continued on next page)

1998, to interim year FY 1999, to interim year FY 2000, to test year 2001, witness Strasser supports the notion that the most recent economic forecast indices be used.¹³ The Commission has often done so in the past,¹⁴ with the object of making the test year cost estimates as accurate as possible.

The chief reason for using the most recent available forecasts is to reduce uncertainty and improve the accuracy of forecasts for a future period of time. This was confirmed by witness Patelunas in response to an OCA interrogatory:

Confirmed that the revised cost level changes based on a later DRI forecast are likely to be more accurate. All things being equal the overall estimate is also likely to be more accurate.¹⁵

OCA witness Rosenberg concurred in this view: "the closer the Postal Service's estimates are to the forecasted period, the more accurate its forecasts are likely to

class and subclass of mail, and to provide revenue estimates, using the current and proposed rates tied to the billing determinants of the post-implementation period for the Docket No. R97-1 rates. As requested in POIR 16, the Postal Service provided in its response the cost coverages that result from combining the updated cost information and the POIR 16 revenue estimates. It is not the position of the Postal Service that such cost or revenue estimates, nor the cost coverages which derive therefrom represent a replacement of the Postal Service's case in chief. It is not anticipated that new rates or new cost coverage proposals will be proposed as a result of the Commission's orders to update the cost and revenue information in this case. Tr. 46C/20926.

Tr. 46A/20277. Counsel: "[I]t is your personal opinion that it is better to use the May-April, the labor costs that result from applying [the] May-April index figure than the figure used in the January filing?"

Witness Strasser: "We determined in our discussions that it presented a more realistic outlook of the anticipated labor cost."

As the Commission has said, it is "general Commission practice [to] us[e] the most current available appropriate information" Further Rec. Dec'n R90-1, App. I at 45.

OCA/USPS-ST44-28 (Tr. 35/16670). With respect to the test year cost estimate, witness Patelunas "[c]onfirmed that the revised cost level changes based on a later DRI forecast are likely to be more accurate." Response to interrogatory OCA/USPS-ST44-29 (*Id.* at 16671).

be."¹⁶ During oral cross-examination, Postal Service witness Strasser conceded that costs based on more recent forecast indices are more "realistic"¹⁷ and "presumably . . . more accurate." Tr. 46A/20361. Indeed, witness Strasser testified that the Order No. 1294 cost updates were based in part upon actual COLA payment increases of \$170 million and that this payment was more certain in the update than it was in the initial filing. Tr. 46A/20276.

OCA witness Thompson presents testimony that displays the breadth of the Postal Service's application of updated economic forecast factors in calculating test year cost level change factors. Tr. 43/18368. These updated factors were obtained by the Postal Service from Standard & Poor's DRI division, a respected economic forecasting organization. The OCA believes that the most reasonable course of action, and the one most consistent with past practice, is the incorporation of the most recent DRI forecast information available in performing the roll-forward of FY 99 data to the test year.

Witness Patelunas updated all personnel and non-personnel cost level factors using "the most recent DRI data available in time to incorporate in the update and still meet the filing deadline." This includes the application of more recent indices to

OCA-RT-2 at 9 (Tr. 41/18308). *Accord*, DMA-ST-2 at 5 (Supplemental testimony of DMA witness Buc; Tr. 38/17189): "As forecasting horizons become shorter, outcomes become more certain and the risk of an outcome lying outside of the forecast decreases."

Tr. 46A/20275. Witness Strasser: "The reason that we filed an update to the ECI is that in fact the ECI inflation had increased and in order to determine more realistic costs that we foresaw in the test year, it was appropriate to update using the new ECI."

Response of witness Patelunas to interrogatory OCA/USPS-ST44-10(d) and (e) (Tr. 35/16650-51).

important pools of costs such as COLA costs under existing labor contracts, fuel and transportation increases, and the ECI assumption.¹⁹ The updating of the ECI index from November 1999 to April 2000 alone resulted in a cost increase of \$185.576 million over and above the initial wage increase estimate. Tr. 46A/20267. This calculation was set forth in OCA cross-examination exhibit OCA/USPS-RT1-XE1 at line 5.

The newer indices were roughly six months more current than the indices incorporated in the initial filing.²⁰ In the interest of constructing test year cost estimates that are as accurate as possible, the newest economic forecast indices should be used by the Commission in developing its cost estimates.

B. The Accuracy of the FY 2000 Cost Estimate and the Test Year Estimate

Is Greatly Improved if Actual FY 2000 Cost Data Are Used

The Commission now has available twelve accounting periods of cost data from the Financial and Operating Statements filed regularly by the Postal Service under Commission Rule of Practice and Procedure 102(c)(2), 39 C.F.R. §3001.102(c)(2). The thirteenth should be available before a recommended decision is rendered. It is the OCA's view that actual cost data collected and reported for almost all of FY 2000 is eminently preferable to the FY 2000 roll-forward presented by witness Patelunas in his supplemental testimony.

Response of witness Patelunas to interrogatory OCA/USPS-ST44-32 (Tr. 35/16675-76); and his response to interrogatory OCA/USPS-ST44-48 (Tr. 46D/21582-83).

Response to interrogatory OCA/USPS-ST44-30 (Tr. 35/16672). The updated DRI Control forecast was released six months after the original forecast, and the updated DRI Trend forecast, which is issued quarterly, was released three months later than the original forecast. However, *data* from March and April were reflected in the forecast index used by the Postal Service. Tr. 35/16824. Witness Thress sheds light on DRI's forecasting procedures, indicating that new data are input on a monthly basis even though the model is re-specified on a quarterly basis. *Id.* at 16860.

Indeed, obtaining actual rather than estimated data was the premise for the Commission's directive to the Postal Service to update its cost estimates from FY 1998 to FY 1999. The Commission stressed that:

All of the comments provided in response to NOI-2 recognize that actual costs are a more accurate representation of FY 1999 experience than estimates developed by rolling forward FY 1998 costs. . . . Actual data are obviously more accurate than estimates, and forecasts beginning with actual data are preferable to forecasts beginning with estimates.²¹

The Postal Service conceded this point in response to an OCA interrogatory:

As a general concept, forecasts beginning with actual Fiscal Year data are preferable to forecasts beginning with estimates.²²

As the Postal Service continued its response, it questioned the practicality, desirability, and materiality of performing such an interim year update. However, the task of updating the FY 2000 cost estimate to reflect actual costs incurred through AP 12 is not nearly so formidable as the Postal Service suggests. Both the OCA and DMA witness Bernheimer have presented methodologies on the record for a fact-based FY 2000 estimate as opposed to the more hypothetical estimate formulated by witness Patelunas.

During the cross-examination of witness Strasser, the OCA introduced a cross-examination exhibit that compared FY 2000 Operating Plan Expenses with Actual FY

Order No. 1294, "Order on the Use of FY 1999 Data," issued May 26, 2000, at 3.

Postal Service response to OCA/USPS-ST44-33 (redirected from witness Patelunas), Tr. 46B/20931. Witness Patelunas added that "workload and time constraints" prevented his inclusion of actual FY 2000 data. Patelunas response to interrogatory OCA/USPS-ST44-6 (Tr. 35/16644).

2000 Expenses,²³ with the object of constructing a realistic FY 2000 cost estimate that incorporated as much actual FY 2000 cost data as possible.

The cross-examination exhibit set forth actual expenses from each of the Financial and Operating Statements ("FOS") for accounting periods AP 1 through AP12, PFY 2000. These statements are filed periodically (*i.e.*, each accounting period), pursuant to Commission Rule 102, 39 C.F.R. § 3001.102. The OCA used total expense figures reported at page one of each of these statements. The only accounting period for which actual expense data were not available is AP 13, which runs from August 12, 2000, to September 8, 2000 (the end of the postal fiscal year). In place of actual AP 13 data, the OCA used the budgeted Operating Plan Expense figure for AP 13 that had earlier been provided by the Postal Service in response to an OCA interrogatory.²⁴

Based on the hypothetical premise (now established as correct) that the budgeted Total Operating Plan Expenses are an apples-to-apples comparison with FOS actual Total Expenses, witness Strasser agreed that it is reasonable to substitute the budgeted Operating Plan Total Expense figure for AP 13 for the as-yet-unknown AP

OCA/USPS-RT1-XE 3 ("Comparison of FY 2000 Operating Plan Expenses with Actual FY 2000 Expenses"), Tr. 46A/20321.

Postal Service response to interrogatory OCA/USPS-T9-27, "U.S. Postal Service FY 2000 Operating Plan," line for "Total Expenses," Tr. 21/9219. There was some confusion during oral cross-examination whether comparing Operating Plan expenses with Total FOS expenses is an apples-to-apples comparison. It is clear that the comparison is appropriate for two reasons. First, the Operating Plan that the Postal Service is in the process of preparing for FY 2001 will present total expenses, not merely operating expenses. Tr. 46A/20314. Second, an examination of the FOS reveals that the Actual Total Expense amount for each AP is compared to a "Budget" figure to determine the "Variation to Budget." In the AP12 FOS, for example, the Total Expense Budget figure is given as \$5,008.6 million. This is the same figure (with rounding) that appears at Tr. 21/9219 for AP 12, i.e., \$5,008,615,000.

13 actual expense figure.²⁵ Furthermore, if the substitution of the Operating Plan AP 13 figure for the actual (unknown) AP 13 figure is reasonable (and witness Strasser agreed that it is), this causes the total expense figure for FY 2000 based upon 12 FOS plus the AP13 Operating Plan substitution to be a reasonable estimate of total PFY 2000 costs. The total figure presented in the cross-examination exhibit is \$64.282 billion (rounded).

Two final steps are needed to transform the PFY total expense figure to a GFY total expense figure. The first is that expenses must be added to the PFY figure because GFY 2000, a leap year, is two days longer than the PFY (366 versus 364).²⁶ Accounting for the two-day discrepancy is simple and straightforward due to the availability of a summary figure representing this very difference from a Postal Service library reference.²⁷ According to the library reference, the incremental cost is \$172

Witness Strasser: "To assume that we're going to make our expense plan?"

Counsel: "Yes."

Witness Strasser: "I guess or hope that that would be reasonable."

Also, at *id.* at 20315. Counsel: "[S]o if the operating plan expenses are total expenses for FY2000, just as you say you would present similar information to the Board of Governors in FY2001, then I can have some confidence in my total figure for AP-13 with the substitution of an operating plan expense figure for AP-13 for the actual figure; is that right?"

Witness Strasser: "For the actual figure representing the Postal Fiscal Year?"

Counsel: "For the Postal Fiscal Year, right."

Witness Strasser: "I guess that's reasonable."

Tr. 46A/20313. Counsel: "I'd like to see whether my step and using the AP-13 expense figure is a reasonable one. Would you agree with me right off that it's reasonable to make that substitution?"

Response of the Postal Service to interrogatory OCA/USPS-ST44-34 (redirected from witness Patelunas). Tr. 46C/20932-33.

USPS-LR-I-489, "Integrated Financial Plan FY 2000" at 7.

million.²⁸ Therefore, to construct a GFY estimate, one would add \$172 million to the \$64.282 billion PFY figure. This equals \$64.454 billion.

The second step, accounting for the shift in time from a PFY beginning September 11, 1999, to a GFY beginning October 1, 1999, is not as readily determined. Witness Strasser was not able to provide the OCA with an estimate of the potentially higher costs that result from the three-week shift, nor has the OCA been able to compute the amount. Tr. 46A/20319. It is likely, however, that the three-week shift has a *de minimis* effect on the total cost figure, since it only reflects the difference between the costs for three weeks of 2000 versus the same three weeks of 1999.²⁹ The OCA submits that, even recognizing that some adjustment will be made to account for the three-week time shift, the \$64.454 billion is a very good proxy for total expenses in GFY 2000. ³⁰

The \$64.454 billion figure calls into grave doubt the total accrued cost figure of \$65.1715 billion presented by witness Patelunas in his exhibit USPS-ST-44A.

Entered into evidence as page 2 of OCA/USPS-RT1-XE3. Tr. 46A/20321A. It would appear that only one additional workday occurred as a result of the 2-day GFY/PFY discrepancy. Furthermore, according to the cited page of the library reference, a proportional amount of revenue arises as a result of the extra workday, along with the extra expenses.

For example, at the July Board of Governors meeting, Mr. Strasser reported to the Board that among the major unplanned cost increases in FY 2000 were an additional \$100 million of workers' compensation expenses, \$240 million of fuel cost expenses, and COLA increases of \$50 million, summing to \$390 million. Response of witness Patelunas to interrogatory OCA/USPS-ST44-32 (Tr. 35/16675-76.) If these increases arose more or less uniformly throughout the year, then a little under 6 percent of them (3 weeks/52 weeks = 5.8%) would have arisen during the three-week period in question. This is a mere \$22.6 million. It must also be borne in mind that union contracts were in place for all major employee unions in FY 2000. Therefore, apart from the unexpected COLA increase mentioned in the *PostCom* article, ECI is not at issue for FY 2000. This is made evident in witness Patelunas' Exh. USPS-ST-44AB, in which the same ECI figure is cited for both the original and the revised filing.

It should be noted that DMA witness Bernheimer calculated an FY 2000 Total Expense figure of \$64.5135 billion, quite close to that calculated by the OCA. DMA-ST-3 at 3 (Tr. 46A/20421).

Patelunas' figure was calculated by rolling forward FY 1999 costs to FY 2000 by means of a complex set of roll-forward factors. The OCA submits that witness Patelunas has likely overstated FY 2000 costs by up to approximately \$700 million. Furthermore, since the FY 2000 cost estimate presented in Exh. USPS-ST-44A is the basis for the roll-forward to the test year 2001 cost estimate, almost certainly the test year total accrued cost estimate of \$68.3575 billion (also set forth in Exh. USPS-ST-44A) is significantly overstated. A roll-forward from a more accurate FY 2000 cost estimate of \$64.454 billion (adjusted for the time shift) would likely yield a test year cost estimate of about \$67.7 billion. It is the OCA's position that the Commission should use a more realistic FY 00 cost estimate to roll forward to the test year.

C. Other Updates Should Not Be Used Unless They Reflect Historical FY 2000 Experience

The OCA believes that a critical distinction must be made between cost updates made in response to Order No. 1294 that are based upon objective, verifiable sources of information on the one hand, and subjective, judgmental sources of information on the other. The OCA urges the Commission to incorporate the former wherever possible, but categorically reject the latter.

Convinced of "the importance of using the latest available information," in Order No. 1294, the Commission articulated its primary goal of incorporating "actual FY 1999 CRA cost data, which provide unit costs by subclass and service . . . into the cost projection process." The OCA naturally adheres to this view—it makes eminently good sense to use the most recent and the most accurate data available to estimate test year costs.

The OCA, therefore, urges the Commission to use FY 1999 CRA data as the starting point for the projection of costs to the test year. Likewise, FY 2000 data, which should shortly be available to the Commission through AP 13, should be used where possible.

The merit of using historical information is in stark contrast with the pitfalls inherent in permitting subjective, judgmental adjustments of costs quite late in the proceeding, when the participants have had little or no opportunity to probe the underlying bases for such adjustments. At the forefront of such objectionable adjustments are those updates made by witness Patelunas in conformance with assumptions contained in the elusive FY 2001 Operating Budget.

Witness Patelunas increased two types of major costs to make them "consistent with the proposed FY 2001 Operating Budget," (USPS-ST-44 at 6 and 3) *i.e.*, workers' compensation costs were increased significantly from the original filing, ³¹ as were cost estimates that approximate the increase in bargaining unit wages that will be negotiated and made effective in the test year. The shorthand for this latter controversy is now familiarly known as ECI versus ECI-1. The ECI issue will be addressed at length in the next section of the brief, but the OCA notes here the Presiding Officer's admonition that "parties may argue the significance of . . . facts [relating to the proposed FY 2001 Operating Budget] to the Commission as they relate to the weight the Commission

Witness Patelunas' responses to interrogatories OCA/USPS-ST44-16 and 17 (Tr. 35/16657-58).

should give to statements of Witness Patelunas and other witnesses, that testimony is consistent with the fiscal operating 2001 budget."³²

The Postal Service vigorously opposed the OCA's efforts to obtain the FY 2001 operating budget referred to in witness Patelunas' testimony. The controversy over the proposed operating budget referred to by Patelunas came to an end with the astonishing statement by the Postal Service that, on the eve of FY 2001, no operating budget exists.³³ Given the lack of verifiable information to support witness Patelunas'

This assertion, that the detailed operating plan consists of the information presented in the FOS for each AP, is an odd and puzzling one. The Financial and Operating Statements report actual costs and revenues that have already been spent or received, not the Postal Service's forward-looking expectations about what expenses and revenues will be.

Following the second vain attempt to obtain the proposed FY 2001 Operating Plan, the OCA filed a motion to compel a responsive answer. ("Office of the Consumer Advocate Motion To Compel Production of Documents as Requested in OCA/USPS-ST-44-51," August 22, 2000"). In opposition to the OCA motion to compel, the Postal Service filed a statement that:

[S]uch a document does not exist. While some elements of the proposed budget have been agreed upon by postal management, the details are still being formulated. Furthermore, as explained in the Postal Service's Response to Questions Raised at Hearings on August 3, 2000, filed on August 15, 2000, the planning parameters for FY 2001 have not yet been submitted to the Board of Governors for approval.

The Presiding Officer, in Ruling No. 138, had no alternative but to accept at face value Postal Service counsel's representations that the requested FY 2001 Operating Budget "does not exist" (Tr. 46A/20174), and, further, that since "detailed operating plans have not typically been completed at the (continued on next page)

Tr. 46A/20175. Chairman Gleiman read verbatim Presiding Officer Ruling No. 138 into the transcript.

The OCA first asked for the proposed FY 2001 Operating Budget in interrogatory OCA/USPS-ST-44-37. The response made was "The final FY 2001 Operating Budget is not available." A second try was made in interrogatory OCA/USPS-ST-44-51. This time the Postal Service referred the OCA to a Hearing Response filed on August 15, 2000. ("Response of United States Postal Service to Question Raised at Hearings on August 3, 2000", Tr. 46C/21043-44. In this response, the Postal Service claimed that the budget approved by the Board of Governors consists of no more than a "net income goal and a set of planning parameters The Board is not supplied with and does not vote on detailed operating plans." The Financial and Operating Statements issued each accounting period, it is stated, constitute the "detailed operating plan."

[&]quot;Response of United States Postal Service to Motion of the Office of the Consumer Advocate to Compel Production of Documents as Requested in OCA/USPS-ST-44-51," filed August 25, 2000, at 2.

supposedly budget-based adjustments, the OCA urges the Commission to reject the cost changes made by witness Patelunas, *i.e.*, the workers' compensation cost increase and the ECI versus ECI-1 cost increase.

In addition to changes purportedly stemming from the elusive proposed Operating Budget, there are numerous other judgmental changes that were made as part of the Order No. 1294 update. Witness Patelunas was asked to explain the process for making changes to initially filed "other program" and "cost reduction" estimates. He answered:

I did not personally review any of the cost reductions or other programs used to develop my supplemental testimony. It is my understanding that all of the cost reductions and other programs used in the update reflect Postal management's best view of each at the time the update was being prepared. Tr. 46D/21576.

Apart from witness Patelunas, the Postal Service did not make available any other witnesses who could explain and support the "other program" and "cost reduction"

time the Board votes on a budget, which is after the fiscal year has already begun, it is clear that such plans cannot be provided now in response to the OCA's discovery request." (Tr. 46A/20175.) Accordingly, the OCA motion to compel was denied.

However, in apparent acknowledgement of the fundamental unfairness in passing through a \$245 million increase to the revenue requirement with no detailed explanation or support, the Presiding Officer cautioned that parties may wish to argue "the significance of these facts . . . as they relate to the weight the Commission should give to statements of Witness Patelunas and other witnesses, that testimony is consistent with the fiscal operating 2001 budget." The OCA duly makes this argument at this time—the key assumptions utilized by witness Patelunas in his supplemental testimony are supported by nothing in the record other than Patelunas' bare assertion that the assumptions were made "consistent with the FY 2001 Operating Budget." Since, as the Presiding Officer stated in Ruling No. 138, the FY 2001 budget does not exist and is apparently underpinned by incomplete details still in the formulation stage ("Response of United States Postal Service to Motion of the Office of the Consumer Advocate to Compel Production of Documents as Requested in OCA/USPS-ST-44-51," filed August 25, 2000, at 2), such assumptions (including the Postal Service's recent ECI assumption) are based on no record evidence whatsoever. Therefore, as indicated by the Presiding Officer in Ruling No. 138, no weight should be given the assumptions. With respect to the wage increase assumption, the Commission has no alternative but to use the longstanding ECI-1 assumption initially presented by witness Tayman in USPS-T-9.

updates. Given the shortness of time available to the participants to assess the update information, the OCA was unable to develop a chain of evidence leading back to the Postal managers responsible for the specific "other program" and "cost reduction" changes. It is the OCA's view that incorporating important cost changes on so slim a reed, *i.e.*, the mere statement that these are the views of Postal managers, would amount to a denial of due process. Consequently, since no reliable evidence has been adduced to justify and support such changes, the OCA asks the Commission not to incorporate any of these.

D. The Change From ECI-1 to ECI Must Be Rejected

In what appeared to be a major break with established policy, the Postal Service made a costly assumption in responding to Order No. 1294—that it anticipates wage increases in the upcoming contract negotiations on the order of ECI rather than its initial assumption of ECI-1. Of the many unsupported changes made in the Order No. 1294 update, this is by far the most serious.

Witness Patelunas candidly states in his supplemental testimony that

Postal Service wages represent the Postal Service's largest expense, and the ECI is a key index because it is used as a benchmark for estimating changes in test year wage rates for bargaining unit employees whose labor contracts do not extend into the test year. USPS-ST-44 at 2.

Apart from the city carrier union contract, which is in place for the test year, all of the other major unions will begin negotiating new contracts with Postal Service management prior to the expiration of their contracts in November 2000. The Postal Service has long used the ECI as one element in forecasting the amount that wages will go up under the new contracts. In prior rate cases when the Postal Service was

faced with this situation, however, it has always adhered to the position that its rate case test year projections should be limited to ECI-1. Indeed, this was the position initially taken when the Postal Service filed its Request on January 12, 2000. Now, for purposes of estimating wage increases in the test year in the Order No. 1294 update, the Postal Service seemingly has abandoned this policy.

At the time of witness Patelunas' appearance, the Presiding Officer expressed concern about this change of direction and articulated his understanding of the Postal Service's longstanding policy concerning ECI:

[L]et me turn now to a change that you made that I consider to be a change in policy.

In each rate case since the R87-1 docket the Postal Service has employed the assumption that changes in wage rates would be limited to at least one percent below the employment cost index -- this is ECI minus 1.

It was an assumption adopted by the Postal Service following the Kerr arbitration award in 1984.

Since that time rate case projections of Postal wage growth have always been below ECI and Postal Service [w]itnesses have always adhered to the rationale that Postal wages exceeded the comparability standard.

In this case Witness Tayman presented Postal Service projections of Postal wage growth that continued the ECI minus 1 policy.

Now for the first time since R87 in your update you have abandoned the rationale that Postal wages exceed the comparability standard and deviated from the ECI minus something method of estimating wage changes. Tr. 35/16796-97.

The Chairman followed up on his remarks by sending a letter to Postmaster General Henderson³⁴ voicing his concern that "if the Postal Service has abandoned the policy of limiting wage growth to ECI-Minus-One, this separate factor alone will increase Postal Service costs by hundreds of millions of dollars each year beginning in 2001." The amount of this increase is approximately \$245 million, as computed by OCA witness Thompson.³⁵ The Chairman particularly sought the assurance of the Postmaster General that this important policy change had been authorized by the Board of Governors, the PMG, the Deputy PMG, and/or the chief financial officer.

Acting Chief Financial Officer Strasser testified on August 31, 2000 concerning the Postal Service's policy on the use of ECI-1. Witness Strasser left no doubt that, despite the inclusion of \$245 million additional in the Order No. 1294 update resulting from use of an ECI rather than ECI-1 figure, the long-standing policy of the Postal Service had not changed:

And I want to put this flat-out, because it probably will come out today, we did not change our policy. As I mentioned, 1294 did not change policy. Our policy on labor negotiations and contracts remains moderate wage restraint, ECI minus 1. Tr. 46A/20257.

The official position of the Postal Service was also transmitted to the Commission by means of a letter in reply to the Chairman's letter, authored by witness Strasser, under direction from the PMG.³⁶ This unequivocal policy statement countermands any thought that witness Patelunas' \$245 million addition for ECI is

³⁴ Dated August 9, 2000.

³⁵ OCA-RT-3 (revised 8/15/00) at 15 (Tr. 43/18371).

³⁶ Dated September 5, 2000. Tr. 48/22478.

supportable on this record.³⁷ Without doubt, the Postal Service has not met its burden of proof to justify a change in policy for what witness Patelunas accurately describes as the Postal Service's largest expense.

The OCA is compelled to address one final point with respect to the ECI dispute. On several occasions, the Postal Service has tried to divert attention from its costly change from ECI-1 to ECI by discussing the "effective change in wages" for the test year. For example, witness Patelunas testified that "the effective change in wages for the new contract is 2.8 to 3.0 percent, or 1.7 to 1.8 percent less than the Employment Cost Index." This mathematical sleight-of-hand should be completely disregarded.

During oral-cross examination, USPS witness Patelunas indicated that the Postal Service had in effect updated the projected test year wages to be approximately 1.7 to 1.8 percent below the ECI estimate of 4.63 percent. Tr. 35/16785-86 and 16673. In order to understand witness Patelunas' statement, one must understand how the USPS determines the effective rate of wage increases. The first step the Postal Service

Indeed, witness Patelunas was unable to present any credible evidence that the change should be allowed. Upon questioning by Commissioner LeBlanc, witness Patelunas was only able to repeat the following refrain (Tr. 35/16799-800):

[&]quot;No, I didn't make the decision;"

[&]quot;Postal Management after reviewing conditions and trends determined that the ECI assumption was more appropriate for the test year 2001."

[&]quot;I can only refer to this as Postal Management made the decision. I don't know at what level or what particular individuals made that decision."

[&]quot;I was instructed to do it."

[&]quot;I have to think. It's hard to remember exactly back to that."

USPS-ST-44 at 3. Witness Strasser testified orally that the correct question is "whether or not ECI minus 1.7 will or can be achieved in negotiations, or in arbitration" Tr. 46A/20257.

performs is to determine the level of the FY 01 estimated general pay increase. For a given employee category, the average FY 00 base salary is multiplied by the forecasted rate increase. (In its response to the Commissions Order No. 1294, the Postal Service revised the wage rate increase to 4.63 percent.) The result is the FY 01 general pay increase. Then, "carry over" costs are deducted from the general pay increase to determine the FY 01 "residual." ("Carry over" costs consist of two elements: (1) an FY 00 general pay increase, and (2) an FY 00 COLA adjustment.) The "residual" is that portion of the wage increase related solely to the FY 01 "new" contract.

To help clarify what occurs, consider the following example taken from USPS-LR-I-421. ³⁹ The Postal Service estimates the FY 00 average mail handler's base salary to be \$35,591.52. *Id.* Mail handlers are expected to receive a general pay increase in FY 01 of \$1,646.99 (\$35,591.52 * 4.63%). The Postal Service estimates that mail handler FY 00 "carry over" costs are \$66.61 for the general pay increase, and \$703.70 for the FY 00 COLA increase. The "residual" is \$876.65 (\$1,646.96 - \$66.61 - \$703.70).

Assuming an effective implementation date of November 18, 2000, the "residual" is adjusted to reflect the equivalent annual amount. In our example, the annual amount is \$1,009.39 ((\$876.65 * 365) ÷ (365-48)). *Id.* Then, the Postal Service calculates the FY 01 effective rate of change in wages. Continuing with the example, the effective rate of the increase is 2.84 percent (\$1,009.39 ÷ \$35,591.52). The Postal Service calculates the difference between their ECI assumption (4.63 percent) and the

USPS-LR-I-421, file name UNCST_EST.XLS, worksheet GEN-INC.

estimated effective wage rate increase (2.84 percent) to be approximately 1.7 to 1.8 percent.⁴⁰

During cross-examination, USPS witness Strasser refers to ECI - 2.1.⁴¹ In its original filing, the Postal Service's test year ECI assumption was 3.87 percent.⁴² Originally, the Postal Service assumed that wage increases were based upon ECI – 1. Given an ECI of 3.87 percent, and an FY 01 ECI-1 wage increase, the effective wage rate increase estimate was 1.7 to 1.8 percent.⁴³ (Please note that the "original" effective FY 01 wage increase of 1.7 to 1.8 percent is comparable to the 2.84 percent in the "revised" filing and only coincidentally similar to the 1.7 to 1.8 mentioned in the previous paragraph.) Consequently, in the original filing, the Postal Service estimated that the difference between ECI (3.87 percent) and the effective FY 01 wage increase (1.7 to 1.8 percent) was 2.1 percent, or ECI - 2.1.

It is essential that the participants and the Commission not lose sight of the fundamental assumption that drives the new contract wage increases—ECI-1 versus ECI and the \$245 million difference between the two. Although the subtraction of carryover costs is a necessary step to compute the total wage increase additions for FY 2001, the fact is that the carryover costs are already set by existing contracts.

 $^{^{40}}$ Tr. 35/16673; Tr. 35/16785-786; and USPS-LR-421, file name UNCST_EST.XLS, worksheet GEN_INC.

Tr. 46A/20274. See also the letter to Chairman Gleiman from Acting Chief Financial Officer Strasser, Jr. dated September 1, 2000.

USPS-LR-127, file name UNCST_EST.XLS, worksheet GEN_INC.

⁴³ Id.

Arithmetically combining these carryover costs with wage increases derived from application of the ECI assumption and reporting their difference from ECI is a meaningless exercise. No importance should be attached to it. The vital point is that the Postal Service has now made clear that is has not abandoned its longstanding rate case practice of calculating test year wage increases based on ECI-1 and, therefore, that the \$245 million included in the Order No. 1294 update must be removed in the Commission's recommended decision.⁴⁴

Finally, the OCA notes that witness Strasser, while urging the Commission to make its decision based upon the Postal Service's original filing, attempts to cover all bases by asking the Commission that, if the Commission uses any of the Order No. 1294 update material, it should "include all the updates included in witness Patelunas' roll-forward." Tr. 46A/20209. This presumably would include the \$245 million resulting from Patelunas' use of ECI rather than ECI-1. This ploy must be rejected. As the senior Postal Service policy witness in this proceeding, witness Strasser has emphatically stated that the Postal Service continues to adhere to ECI-1, and no credible evidence points to the contrary. The Postal Service cannot have it both ways.

E. The Breakthrough Productivity Increases Should Be Incorporated, but the \$200 Million Field Reserve Should Be Rejected

Postmaster General Henderson proudly announced at the March Postal Forum that he had instructed his management team to launch initiatives that will reduce Postal

As discussed earlier, however, the OCA agrees that the more recent DRI data on the ECI (as potentially further updated by the Commission) should be included. This change in the underlying ECI (from 3.87 percent to 4.63 percent) adds \$186 million to the Postal Service's test year costs. Tr. 46A/20267.

Service expenses by "at least" \$4 billion by 2004. The initiatives were identified by the slogan "Breakthrough Productivity" and included overhead reductions of \$100 million per year, \$100 million annual savings resulting from more efficient paperwork and purchasing, a \$100 million reduction in transportation costs per year, and finally, mail processing cost reductions of \$700 million per year.⁴⁵

When questioned by the OCA about the details of the \$1 billion per year savings touted by the PMG, at first the Postal Service was reluctant to commit to specific savings for the test year, even though it was evident from the PMG's speech that approximately the first \$1 billion of the total \$4 billion savings would be achieved in FY 2001.⁴⁶

In response to Presiding Officer's Information Request No. 13, witness Tayman backed off dramatically from the \$1 billion per year savings announced by the PMG. According to Tayman, the total test year savings for Breakthrough Productivity would only be \$550 million, not \$1 billion. In Presiding Officer's Information Request No. 14, the Presiding Officer pressed for a detailed explanation of the discrepancy between the PMG's speech and witness Tayman's statement that only \$550 million of savings would be achieved. Witness Patelunas provided the POIR 14 response, indicating that cost savings were reduced by \$200 million as a result of a "Field Reserve [that] recognizes

[&]quot;Remarks by Postmaster General and CEO William Henderson at the Postal Forum, Nashville, TN," March 20, 2000, at 3 (Tr. 38/17197).

Response of the Postal Service to interrogatory OCA/USPS-98 (Tr. 21/9152): "it is premature to speculate on the years in which the savings are expected to be realized and the amounts of the savings expected for each year."

the difficulty in achieving the aggressive cost reductions in FY 2001, the first year of the Breakthrough Productivity Initiative."⁴⁷

Witness Patelunas updated cost reductions for the test year to incorporate, in part, "the impact of breakthrough productivity." USPS-ST-44 at 5. However, it was Patelunas' intention to remove the \$200 million from the pool of cost reductions as a Field Reserve. Tr. 35/16784. Apparently he failed to do so.⁴⁸

It is the position of the OCA that the full \$744 million of Breakthrough Productivity savings reported by witness Patelunas in response to POIR No. 14 be applied in the test year to reduce costs.⁴⁹ Unlike many of the other cost reductions criticized by the OCA as bare assertions by unnamed managers, the Breakthrough Productivity analysis has impeccable credentials.

First, the PMG himself has made a public commitment to save at least \$4 billion over four years, resulting in the Patelunas POIR No. 14 estimate of \$744 million of Breakthrough Productivity savings in the test year. It is reasonable to expect that if the Postmaster General marshals his troops to achieve a highly visible and specific goal, every Postal Service employee will be working to produce the desired result. In addition, the nature of the cost savings has been thoroughly detailed by means of responses to discovery requests and Presiding Officer Information Requests. By

⁴⁷ Attachment I, n. 2. Tr. 46D/21595.

See Errata to witness Patelunas' response to POIR No. 14, filed August 11, 2000.

The OCA realizes that the FY 2001 Breakthrough Productivity savings identified by witness Patelunas are \$744 million rather than \$1 billion. Recognizing that major reforms take some time to ramp up and realize their effect, the OCA will accept the \$744 million figure for purposes of the test year.

contrast, the "other program" costs and "cost reductions" discussed in section I.C. above were made by nameless managers whose "best views" were apparently polled by other nameless individuals and passed along to witness Patelunas. Unlike the situation with Breakthrough Productivity, such scanty justification can be given little credence.

The Field Reserve, on the other hand, should not be utilized as a means to reduce the estimated Breakthrough Productivity savings. The Postal Service already has a hedge, in the form of a contingency, against the possibility that all of the planned Breakthrough Productivity savings will not be achieved. The contingency amount proposed by witness Rosenberg, for example, is ample enough to absorb \$200 million of cost reductions if, despite its best efforts, the Postal Service is unable to achieve the \$744 million of reductions and incurs \$200 million as expenses. Witness Rosenberg proposes a one percent contingency that would generate a \$671.9 million to \$683.6 million hedge against unachieved Breakthrough Productivity. Even if the Postal Service were to fail to reduce costs by the \$200 million in question, \$471.9 million to \$483.6 million would remain for other misestimates or uncertainties.

F. The Updated Workyear Mix Adjustment Must Be Rejected

The Order No. 1294 update contains a revised workyear mix adjustment for the test year. The workyear mix adjustment ("WMA") "reflects the anticipated shifts in work load due to automation, and refined scheduling and hiring practices." USPS-T-14 at 4.

OCA-RT-2 at 4 (Tr. 41/18303). The range of figures reflects differences resulting from the use of original or updated cost estimates, either before rates or after rates.

Traditionally, the WMA reduces the revenue requirement.⁵¹ In the initial filing the WMA produced a reduction in the revenue requirement of \$2,658,000. In the Order No. 1294 update, however, the WMA *increased* the revenue requirement by a stunning \$213,750,000. Thus, the WMA increased nearly one-hundred-fold and went in the opposite direction. The net effect of the "updated" adjustment was a \$216,408,000 increase in the revenue requirement. Tr. 43/18363.

The Commission should not recognize the revised WMA as a test year expense. The Postal Service has done a poor job of explaining this adjustment; the impact on the revenue requirement is the opposite of what would be expected of a "traditional" WMA; and—to the extent the Postal Service's explanation can be understood—the adjustment is, effectively, another "Field Reserve" to protect against the possibility that management will fail to achieve the planned test-year mix of straight time, overtime, TE hours, and casual hours.

1. The Order No. 1294 Workyear Mix Adjustment is poorly explained
Witness Patelunas' "explanation" for the revised WMA, reproduced below, is
simply incomprehensible.

The workyear mix adjustment was updated to reflect the impact of FY 99 actual personnel costs and the FY 99 actual workyear mix. The overtime assumption was updated to reflect the overtime planned in the FY 2000 operating budget and the fact that overtime is currently over plan. The Transitional Employee (TE) workyear assumption was updated to reflect the actual number of TE's through Accounting Period 9, PFY 2000. The career employee retirement assumption was updated to reflect

[&]quot;[The] adjustment for workyear mix . . . reduces overall payroll expense by assuming an increase in the proportion of transitional employees to permanent employees and a decrease in overtime." PRC Op. R94-1, ¶ 2019 (emphasis added).

FY 99 actual retirements. As a result of large cost reductions and minimal workload increases in the test year after rates, workyear reductions are required that are in excess of the number that will result from estimated retirements for career clerks and mail handlers. Since TE workyears are derived separately, and overtime is currently running over plan, the additional workyear reductions required to balance to the total estimated after rates test year clerk and mail handler workyears were assumed to be taken from casuals.

USPS-ST-44 at 7.

Consider the first sentence. It is either tautological or cryptological. In an update intended to reflect a 1999 base year, one would expect to provide actual 1999 data as input to a WMA model. Thus, the first sentence would appear to be unnecessary, unless it represents an oblique reference to an abnormal treatment of actual 1999 data. The second sentence is another enigma. Why not simply say, "The overtime assumption was updated to reflect actual FY 2000 experience"? And should this sentence be interpreted to mean, "The overtime assumption was updated on the presumption that management will make no effort to reduce excessive overtime in FY 2001"?

The third sentence, relating to the number of Transitional Employee workyears, also sounds so innocuous as to be unnecessary. Or does it signal another unusual estimation procedure? What happened to the expert judgment of headquarters managers? All of a sudden the future of TE workyears is identical to AP 9, PFY 2000. And the same question can be asked with respect to the retirement assumption. Do the expert headquarters managers have absolutely no information to suggest that FYs 2000 and 2001 might show a different pattern of retirements from FY 1999?

But the epitome of incomprehensibility comes in the last two sentences. As the OCA translates these sentences, the Postal Service believes that cost reductions (affecting flats?) aren't really achievable ("excess"). So the Postal Service reconciles this internal inconsistency by shedding casual rather than career workyears for clerks and mailhandlers. This adjustment produces a \$216 million increase in the revenue requirement. Instead of being a fact-based adjustment, the revised WMA appears to be another form of "Field Reserve" to protect the Postal Service from a reduction in its overstated contingency request.

 The updated Workyear Mix Adjustment represents an abandonment of long-standing Postal Service policy

Witness Patelunas states that

the additional workyear reductions required to balance to the total estimated after rates test year clerk and mail handler workyears were assumed to be taken from *casuals*.

USPS-ST-44 at 7 (emphasis added). Casual (or part time) employees are the least costly source of Postal Service labor. One would expect postal management to use casual employees at every opportunity in order to minimize labor expense. Indeed, failure to do so when the opportunity is presented would seem contrary to the statutory mandate for honest, economical, and efficient management.

However, labor contracts constrain the use of casuals within each craft. The Docket No. R94-1 WMA model contained explicit verbal directions on how to include these contract constraints in the model:

Enter the FY 94 casual limit percentage for clerks & city carriers (4.5%) and mailhandlers (15.5%). These percentages are applied to career base

workyears to determine the number of base casual workyears consistent with contractual limits.

LR-G-156, Part 3, first unnumbered page. In Docket No. R2000-1 there are no explicit verbal instructions for setting up the WMA model. Rather, it now appears that the model can be manipulated so as to shed casual workyears first instead of the economical last. It is difficult to believe that between Docket Nos. R94-1 and R2000-1 the Postal Service has reversed policy and—in a time of severe budgetary constraints—now wants to use expensive career employees in place of part-time casuals. The more likely inference is that the Order No. 1294 WMA model update contains padding—i.e., a "Field Reserve." The Postal Service's unsupported WMA update must be rejected.

II. THE CONTINGENCY SHOULD REMAIN AT ONE PERCENT

Based primarily on the testimony of witness Tayman, the Postal Service has proposed a contingency of 2.5 percent—in absolute dollars, \$1.68 billion. This constitutes an unprecedented 60 percent of the requested increase in revenues. Table 1, below, shows that in past rate cases the contingency averaged approximately 26 percent of the requested revenue increase. As can be seen, the contingency has never comprised more than 34 percent and, in one case, was only 14 percent. A revenue increase driven primarily by the proposed contingency (the Postal Service's present request) must be scrutinized more carefully than earlier rate cases that were driven largely by projections of increases in specific costs. By contrast, the one percent contingency proposed by OCA witnesses Rosenberg and Burns results in a contingency of \$0.6719 billion, and represents a more acceptable 38 percent of the

total increase in revenues. Even so, it would become the largest contingency proportion ever recommended by the Commission, as measured in comparison to the revenue increase.

TABLE 1: Comparing the Postal Service's R2000-1
Contingency Proposal with Prior Rate Cases

Case	Requested Increase in Revenue	Amount of Contingency	Contingency/Revenue Increase
R76-1	\$2.31 billion ⁵²	\$0.54 billion ⁵³	23%
R77-1	\$1.97 billion ⁵⁴	\$0.66 billion ⁵⁵	34%
R80-1	\$3.75 billion ⁵⁶	\$0.54 billion ⁵⁷	14%
R84-1	\$3.11 billion ⁵⁸	\$1.0 billion ⁵⁹	32%
R87-1	\$4.3 billion ⁶⁰	\$1.3 billion ⁶¹	30%
R90-1	\$6.16 billion ⁶²	\$1.6 billion ⁶³	25%
R94-1	\$4.11 billion ⁶⁴	\$1.05 billion ⁶⁵	26%
R97-1	\$2.24 billion ⁶⁶	\$0.6 billion ⁶⁷	27%
R2000-1 (2.5 %)	\$2.8 billion ⁶⁸	\$1.68 billion ⁶⁹	60%
R2000-1 (1 %)	\$1.7815 billion ⁷⁰	\$0.6719 billion ⁷¹	38%

Average proportion of contingency to revenue increase for the eight omnibus rate cases is 26.4%.

OCA-RT-2 at 4 (Tr. 41/18303).

USPS Request, filed December 19, 1975.

⁵³ PRC Op. R76-1 at 19.

USPS Request, filed July 13, 1977.

⁵⁵ PRC Op. R77-1 at 42.

USPS Request, filed April 21, 1980.

⁵⁷ PRC Op. R80-1, ¶0138.

USPS Request, filed November 10, 1983.

PRC Op. R84-1, Appendix A.

USPS Request, filed May 10, 1987.

PRC Op. R87-1, Appendix A.

USPS Request, filed March 6, 1990.

PRC Op. R90-1, Appendix A.

USPS Request, filed March 8, 1994.

⁶⁵ PRC Op. R94-1, Appendix A.

USPS Request, filed July 10, 1997.

⁶⁷ PRC Op. R97-1, Appendix C.

USPS Request, filed January 12, 2000, at 2.

⁶⁹ Exh. USPS 9A

The Postal Service's proposed contingency of \$1.6798 billion (Exh. USPS-9A) is \$1.0069 billion higher than witness Rosenberg's proposed contingency of \$0.6719 billion (OCA-RT-2 at 4; Tr. 41/18303). If a commensurate \$1.0069 billion reduction is made in the Postal Service's requested total increase in revenue, *i.e.*, \$2.7884 billion (Postal Service Request at 2), then the total increase in revenue would be approximately \$1.7815 billion. 0.6719/1.7815 = 37.7%

In light of the Postal Service's current fiscal health, its record-setting string of yearly net incomes,⁷² its very favorable equity restoration position,⁷³ and a stable economy, the one percent contingency underlying current rates provides ample opportunity for the Postal Service to break even in the test year.

A. The Evidence Supports Only a One Percent Contingency Provision

The OCA has filed testimony by two witnesses, Edwin Rosenberg and Robert Burns, urging the Commission to recommend a contingency of one percent. In witness Rosenberg's two pieces of testimony, OCA-T-3 (Direct Testimony) and OCA-RT-2 (Rebuttal Testimony), he applies sound public policy and regulatory principles to arrive at the conclusion that the continuation of the current contingency of one percent is all that is required for continued successful operation of the Postal Service and a breakeven result in the test year. Tr. 22/9807. In OCA-RT-2, witness Rosenberg reconsidered his earlier conclusion concerning the proper level for the contingency and found that, with updated test-year cost estimates available that reflected more recent forecasts of test-year inflation factors, there was even more reason to have confidence in the safety afforded by a one percent contingency provision.

OCA witness Burns, in OCA-T-2, reviewed the standards established by the Commission for the evaluation of a proposed contingency request and found that the

The Postal Service has enjoyed large positive net incomes each year from 1995 – 1999. Exh. USPS-9L.

Through 1999, the Postal Service was \$1.683 billion ahead of the cumulative equity restoration target adopted by the Board of Governors. Exh. USPS-ST-44G. Even if the Postal Service were to lose \$325 million in FY 2000 (which is unlikely), it will be cumulatively \$981 million ahead of target.

Postal Service's presentation in this proceeding fell far short of the mark. (OCA-T-2, witness Burns' direct testimony, will be discussed at length in Section III.B of the Initial Brief.)

1. Economic conditions are stable

One of the most contentious issues surrounding the proposed contingency has been the stability of the economy. Curiously, witness Tayman, who bore the responsibility for justifying the two and a half fold increase in the contingency (from one to 2.5 percent), never mentioned economic stability in his testimony. His only reference was a vague statement that "there . . . appear to be significant new pressures on salary and benefit cost levels." USPS-T-9 at 44.

(a) The evidence confirms that stable economic conditions are expected in the test year

In contrast to the hazy, general statements contained in the Tayman testimony, witness Rosenberg performed a rigorous analysis of economic conditions and how they might affect Postal Service finances in the test year. Witness Rosenberg began with a discussion of the type of economic conditions that would make a relatively small contingency possible:

relatively favorable and stable economic conditions at present and forecasts of reasonable stability over the near-term future can be expected to strengthen the ability of the Postal Service to forecast revenues and expenses on a going forward basis, so the Postal Service's estimates would be expected to be more reliable now than in more uncertain times. More accurate forecasts or estimates would tend to allow for a relatively smaller provision for contingencies. Tr. 22/9811-12.

He reviewed macroeconomic forecasts by several respected forecasting organizations—the Congressional Budget Office, Deutsche Banc Alex. Brown, and Standard and Poor's DRI. The Congressional Budget Office presented a picture of marked stability in real GDP, the Consumer Price Index ("CPI"), and the unemployment rate for the test year. Tr. 22/9813. Deutsche Banc Alex. Brown predicted a decline in CPI, slight growth in real GDP, and a slight increase in hourly compensation (Tr. 22/9814), while DRI (whose forecasts the Postal Service itself relies on) projected stability in the CPI and a slight decline in the Employment Cost Index ("ECI") for 2001. *Id.* Witness Rosenberg summed up expected economic conditions in this way:

The United States is currently enjoying the longest economic expansion in

over half a century. We continue to have robust economic growth combined with low and relatively stable inflation. These conditions should allow the Postal Service to meet its responsibilities with a minimum provision for contingencies. Tr. 22/9815.

Oral cross-examination was unable to shake his conviction that:

The ability of the Postal Service to forecast in a relatively stable economic environment ought to be, in my opinion, better than it would be in a less stable economic environment. Also, with inflation relatively low and stable, I think that increases the ability to forecast certain expenses. Tr. 22/9883-84.

The Postal Service made a limited attempt in witness Strasser's rebuttal testimony to undermine witness Rosenberg's conclusions that the economy is strong and stable, with low inflation expected to continue. The Service carped that Dr. Rosenberg had grouped CPI data differently than the Service would group them and

presented a new grouping in Strasser's Table 1.74 Ironically, the Table does little to bolster the Postal Service's position; rather, it lends further support to witness Rosenberg's conclusions.

For example, in three out of the four past rate cases presented in the Table, the Commission recommended a contingency level that was lower than CPI-W; and in every one of the past four rate cases, the contingency provision was lower than ECI. The OCA's one percent contingency compares favorably with earlier proposals in this respect, but the Postal Service's 2.5 percent contingency barely fulfills this condition since the Postal Service, in this proceeding, would recommend a contingency roughly equal to the CPI-W (2.5 percent contingency compared with CPI-W of 2.56 percent).

If one compares the OCA's one percent proposal and the Postal Service's 2.5 percent proposal with the most recent contingency recommendation—one percent in Docket No. R97-1—the Strasser Table clearly shows that the OCA proposal is much more closely aligned to the prevailing economic circumstances surrounding Docket No. R97-1 than is the Postal Service's proposal. In Docket No. R97-1, the recommended contingency of one percent was made against an economic backdrop of CPI-W of 2.26 percent and ECI of 3.5 percent. As shown in the table, the OCA one percent contingency would come close to maintaining this relationship to CPI-W and ECI since

USPS-RT-1 at 15-16 (Tr. 46A/20195-96). Witness Strasser also leveled a blatantly erroneous criticism at witness Rosenberg in stating that: "Witness Rosenberg's analysis is flawed. . . . he relies totally on historical inflation data to correlate inflation and the contingency. But, the data most relevant to the test year are forecasted, not historical data." Witness Strasser was forced to retract the statement and had to retreat to the observation that while witness Rosenberg had not included forecast data in Rosenberg's Table 5, he had clearly used and relied on forecast data in many places throughout his testimony. Tr. 46A/20283-89.

each is projected to rise only slightly, to CPI-W of 2.56 percent and ECI of 4.04 percent for 2001. Thus the gap between the OCA's contingency proposal and that recommended by the Commission in Docket No. R97-1 widened only slightly, from 1.26 percent to 1.56 percent for CPI-W, and from 2.5 percent to 3.04 percent for ECI.

A 2.5 percent contingency, however, deviates significantly from that relationship, causing the contingency to be almost equal to CPI-W and only 1.54 percent lower than ECI. The Postal Service's insistence on a contingency level nearly equal to inflation raises the specter of the moral hazard discussed by OCA witnesses Burns and Rosenberg. Their invocation of accepted views that too large a contingency may be an incentive to slackness⁷⁵ and may create perverse managerial incentives⁷⁶ is clearly germane when the Postal Service is seen to be straining to create a much larger cushion in the instant proceeding than it was allowed in Docket No. R97-1. As witness Rosenberg points out in his direct testimony, putting managers "in the position of having to make decisions to hold down costs . . . may be considered a good thing, since managers *should* be in a position of having to seek ways of controlling costs."

During oral cross-examination, Mr. Strasser conceded that the July 2000 DRI forecast continues to show a downward trend in both CPI and ECI. Tr. 46A/20290-94. This serves as convincing evidence that witness Rosenberg's reliance on predictions for continued economic growth and low inflation is well-founded.

⁷⁵ Tr. 22/9826.

⁷⁶ Tr. 22/9713.

⁷⁷ Tr. 22/9810.

(b) There is no credible evidence of economic turmoil

In an attempt to counter the persuasive testimony of OCA witnesses Rosenberg and Burns and DMA witness Buc on the stability of economic conditions, the Postal Service enlisted the assistance of witness Zarnowitz. But the Zarnowitz testimony lends no assistance to the Postal Service's cause.

At the outset, witness Zarnowitz readily acknowledged that he did not contribute any guidance to the Postal Service in selecting the 2.5 percent contingency, (Tr. 41/18263) nor does he take any position on the appropriate level of the contingency provision. Tr. 41/18265. His testimony is limited to general commentary on current economic trends, but even this is based exclusively on historical data, and does not rely on any forecast data for the test year. Tr. 41/18263. The Zarnowitz testimony, therefore, is limited to an effort to raise questions about the degree to which the Commission should rely on the current generally favorable economic climate in recommending a continuation of the one percent contingency. As will be shown, the Zarnowitz testimony is no impediment to the Commission choosing to maintain a contingency of one percent.

Witness Zarnowitz is a frequent commenter on the business cycle. In articles and interviews published since 1995, he has regularly warned that the present economic expansion will come to a halt.⁷⁸ Indeed, witness Zarnowitz was very frank that his testimony repeats the cautious views on the business cycle that he has espoused for several years. Tr. 41/18270.

⁷⁸ Tr. 41/18230-32; see also 18269-70.

What witness Zarnowitz does not do, however, is to discredit the analysis of OCA witness Rosenberg or DMA witness Buc. Witness Zarnowitz's prepared testimony characterized Rosenberg's and Buc's testimony as overly optimistic and based on belief in a new economic paradigm. Tr. 41/18189-90. But when challenged on the actual content of OCA witness Rosenberg's testimony, witness Zarnowitz repeatedly acknowledged that Rosenberg had not made such broad statements.⁷⁹ Ultimately, all witness Zarnowitz was able to say is that his difference with OCA witness Rosenberg is only in the "degree of confidence" he has in the current strength and stability of the economy.⁸⁰

Other facts emerged that limit the import of the Zarnowitz testimony. Witness Zarnowitz acknowledged that the relevant time period was the test year October 2000-September 2001. Tr. 41/18232-33. He acknowledged that the Postal Service has provided more recent forecasts from DRI, a respected institution, and that more recent forecasts improve the degree of confidence when looking ahead to the test year.⁸¹ He agreed that OCA witness Rosenberg relied on DRI forecasts only through 2001, and that short-range forecasts are more reliable. Tr. 41/19264.

Tr. 41/18268; 18273. Similarly, witness Zarnowitz admitted that DMA witness Buc had not made claims of indefinite prosperity in reaching his recommendation to reduce the contingency. Tr. 41/18242-43.

Witness Zarnowitz also commented in his testimony on the strength of the current economic expansion compared to those of the 1960s and 1980s. Tr. 41/18190-191. But witness Zarnowitz admitted that OCA witness Rosenberg had not made any statements about the strength of the current expansion. Tr. 41/18272. Here again, witness Zarnowitz aimed at a target that was not there.

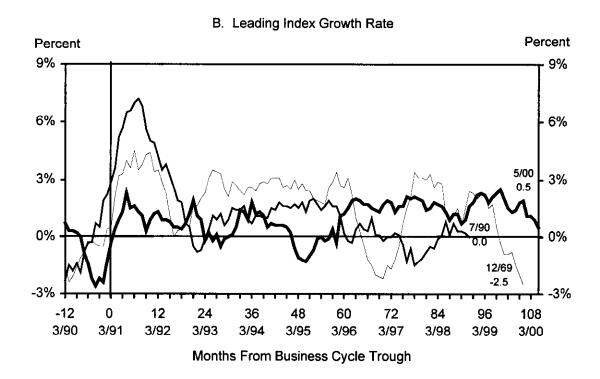
Tr. 41/18268. Witness Zarnowitz also acknowledged that when it comes to economic forecasting, there is a divergence of opinion among reliable and respected sources. Tr. 41/18271.

Tr. 41/18234; see also 18241-42.

Witness Zarnowitz provided numerous charts of historical data with his testimony. A close examination of these data discredits the notion that the economy is likely to become unstable during the test year. For example, real gross domestic product ("GDP"), the key indicator of whether the economy is growing or shrinking, continues to grow.⁸² The coincident index, which tracks the GDP, similarly continues to show an upward trend.⁸³ While agreeing that these indices continue to reflect growth in the economy, witness Zarnowitz cautioned that the leading index currently shows less growth. Tr. 41/18280. But even this comment was put into perspective by a review of witness Zarnowitz's Chart 2(B) on the leading index growth rate. Witness Zarnowitz agreed that when a line is drawn along the 0 percent axis of the chart, one can observe where the leading index growth rate trends down and where it actually turns negative. Tr. 41/18282. Chart 2(B) is reproduced below, with the addition of the line along the 0 percent axis:

Tr. 41/18214, Chart 1(A). Witness Zarnowitz agreed that his GDP data does not show evidence of a slowdown. Tr. 41/18275.

Tr. 41/18278-279. Data on the composite indices since 1979 was provided in OCA/USPS-RT-2-XE-1. Tr. 41/18294-295. The exhibit, which was admitted into evidence (Tr. 41/18293), also provided June figures to update the data through May used by witness Zarnowitz. That data confirmed continued upward growth in the coincident index. Tr. 41/18295.



As can be seen, the leading index currently is trending down but has not turned negative. It did have a period of negative growth in 1995 that coincided with the "soft landing" of that period. Tr. 41/18282. But there have also been three other periods of downward trend during the current expansion, and in each instance the index rebounded without turning negative. Witness Zarnowitz confirmed these facts, all of which occurred during the current and continuing economic expansion. *Id.* In short, there is nothing in the current data on the leading index to suggest that the economy is entering an ominous phase.

Witness Zarnowitz also noted in his testimony that the interest rate spread recently has turned negative (yield inversion), a development that he considers to be an adverse signal. Tr. 41/18182. But close examination of the facts shows that, here again, little can be read into this development. First, witness Zarnowitz acknowledged

that, unlike past instances of yield inversion, recent budget surpluses have meant that the U.S. Treasury has sold fewer long-term bonds. *Id.* Second, review of the data provided in Chart 10 shows that a substantial period of yield inversion occurred during the expansion of the 1960s some three years before the end of that expansion. Similarly, there was a short period of yield inversion in the 1980s expansion, some two years before that expansion ended. Tr. 41/18283-84. Coupled with the fact that witness Zarnowitz acknowledges that the present budget surplus presents different circumstances from past yield inversion situations, (Tr. 41/18286-87), very little significance can be attributed to the recent slight inversion in predicting the short-range (test year) path of the current expansion.

Finally, witness Zarnowitz also acknowledged that he found current data on cost and productivity (Chart 7) and profitability (Chart 8) that are inconsistent with the trends in these factors at the end of the expansions of the 1960s and 1980s. Tr. 41/18284-85. Productivity is significant, because it is a leading indicator. *Id.* Consideration of these positive data led witness Zarnowitz to observe that "[w]e still are in an expansion that is relatively strong compared to the '60s and '80s." Tr. 41/18286.

2. A higher contingency would be counter-productive

Witnesses Tayman and Strasser lament that volume and growth rates continue to be low and fall short of plan.⁸⁴ Concerns about competition from the Internet, traditional domestic competitors, and foreign competitors are voiced. *Id.* Both of these

USPS-T-9 at 43-44; and USPS-RT-1 at 10-11 (Tr. 46A/20190-91).

Postal Service spokesmen lose sight of the fact that needlessly large rate increases exacerbate any slow-growth trends. Witness Rosenberg, on the other hand, explicitly takes this into account as a reason to keep the contingency at its present, moderate level. Worse, he cautions that layering too large a contingency on current rates may trigger a

"vicious cycle" in which rising postal rates create more headroom for competitors, which would result in lower revenues and a call for further rate increases, further encouraging competitors. Tr. 22/9833.

Maintaining the contingency at its present level would impose a wholesome restraint on expenditures. This, in turn, would have a positive impact in meeting postal competition and sustaining volumes and revenues.

It should also be recalled that the extra \$1 billion that would result from increasing the contingency to 2.5 percent is not costless. This amount comes out of the pockets of Postal Service customers in the form of higher rates and fees. Whatever is paid unnecessarily as higher rates cannot be applied to consumption, investment, and saving, thereby causing customers to suffer a lost opportunity.⁸⁵

Generally speaking, postal customers will pay a higher opportunity cost on excess monies that are consumed by the contingency, since businesses usually must borrow at rates well above Treasury rates. This is true also of borrowing by individuals on credit card purchases, automobile loans, and other consumer debt. Furthermore, individuals and businesses may have to forego profitable investment opportunities in instruments such as equity securities that have expected returns far higher than

These points were made by witness Rosenberg in OCA-T-3 at 23-24 (Tr. 22/9827-28).

Treasury rates. *Id.* The lost opportunity cost should be taken into consideration in setting the contingency.

3. The Order No. 1294 cost update dramatically reduces uncertainty for the Test Year

Since the major purpose of the contingency is to allow a cushion for forecast misestimates and unforeseeable events (PRC Op. R84-1, ¶1057.), the dramatic reduction in uncertainty about test year costs arising from the use of FY 1999 costs and recent economic forecast data justifies a low contingency. The OCA asked witness Rosenberg to re-evaluate his recommendation for a one percent contingency in light of the new cost information filed in the Patelunas testimony. The conclusion drawn by Dr. Rosenberg is that: "The use of more current indices is very significant in considering the appropriate level of the contingency provision to be recommended." Tr. 41/18309. This led him to "maintain [his] previous recommendation that a contingency of one percent of total estimated costs be used in this proceeding." Tr. 41/18312.

Through the testimony of witness Strasser, ⁸⁶ the Postal Service seemingly wished to deny the unshakable truth that utilization of more recent economic data and the close proximity of the development of the record in this proceeding to the period of the test year materially reduces uncertainty about interim FY 2000 and test year cost estimates. However reluctantly, witness Strasser did concede that updating the new ECI resulted in "more realistic costs" (Tr. 46A/20275) and that use of the more recent ECI index gives a more realistic picture of labor costs for the test year. Tr. 46A/20276-

⁸⁶ See, e.g., Tr. 46A/20247-48 and 20274-75.

77. Indeed, witness Strasser agreed that the inclusion of more recent COLA payment information made that element of the cost update more certain.⁸⁷ Upon questioning by Commissioner Goldway, Mr. Strasser admitted that more recent forecasts are more "accurate." Tr. 46A/20361.

Postal Service witness Zarnowitz was more candid in sharing his views on the inverse relationship between certainty in forecasting and length of the forecast period, *i.e.*, as the length of time between the forecast period and the forecast is shortened, there is more certainty in the accuracy of the forecast. Tr. 41/18234. Witness Zarnowitz's view is that forecasts one to two years out have a "certain amount of reliability," and that the forecast demands of this case, which are well within the one-to-two-year window, should allow for a fairly reliable forecast. *Id.* Witness Zarnowitz added that accuracy decreases quarter by quarter. *Id.* Therefore, the use of economic forecast data that are two quarters more recent than that contained in the initial filing greatly diminishes the uncertainty of the cost estimates.

This principle has been acknowledged in earlier Commission opinions. In PRC Op. R94-1, for example, the Commission recognized that "the closer proximity of the test year than in past rate proceedings" inspired greater confidence in a lower-than-average contingency. PRC Op. R94-1, ¶2042.

Tr. 46A/20276. It should not be forgotten that wages established by the city carrier contract is a known fact for TY 2001. Only the COLA provision applies to city carriers in the test year.

It should also be noted that the Postal Service's recent re-examination of its volume forecasts inspires confidence as well. Witness Strasser testified that "interim period volume projections have tracked well with actual results."88

4. The continuing fiscal health of the Postal Service permits retention of a moderate contingency

Witness Rosenberg finds it significant that the Postal Service has demonstrated the ability to manage well financially with contingency provisions of two and one percent since the Docket No. R94-1 case. Positive incomes have been realized in every year since 1995, a critical fact that witnesses Tayman and Strasser overlook. At the time that Dr. Rosenberg wrote his direct testimony, he calculated that the Postal Service had generated cumulative net income of \$5.58 billion from 1995 – 2000.

He underscored that:

In each year since implementation of the rates approved in R94-1, the Postal Service has operated quite successfully with a contingency provision less than the 2.5 percent it has requested in this Docket. Tr. 22/9815.

The Commission views the financial condition of the Postal Service as an important factor in determining the level of the contingency needed. The earlier era of high contingencies, e.g. four percent in Docket No. R76-1, arose in the context of the Postal Service's "chronic deficit position." PRC Op. R76-1 at 57. Explaining its reasons for recommending a four percent contingency, the Commission stated:

We must take into account . . . the ability of the Postal Service to absorb the consequences of erroneous predictions of costs and revenues. . . .

USPS-RT-1 at 1-2 (Tr. 46A/20181-182). See also questioning of witness Strasser by Chairman Gleiman. Tr. 46A/20393-94.

[T]he Service's frequent underestimation of costs and overestimation of volumes and revenues have left it highly vulnerable to the consequences of such errors. Its chronic deficit position increases its vulnerability to revenue shortfalls or cost increases. . . . Given the present financial condition of the Postal Service, this factor suggests that a relatively high level of protection against contingencies is appropriate. *Id*.

At the present time, the Postal Service finds itself found in the opposite condition. Witness Rosenberg describes the Postal Service's recent era of success in this way: Tr. 22/9815.

The recent experience of the Postal Service is that it has been able to achieve a positive net income over the two most recent rate cycles with a contingency provision less than the 2.5 percent requested. . . .

Unlike some situations that the Postal Service has experienced historically, there is no chronic or growing deficit resulting from an over forecast of revenues and/or under forecast of expenses. As shown in Mr. Tayman's Exhibit 9L, the Postal Service has achieved a positive net income in every year since 1995 and is projected to do so during FY 2000.

In fact, during the 1995 through 2000 period, the Postal Service generated a cumulative net income of \$5.58 billion.

This consideration weighs heavily in witness Rosenberg's conclusion that the contingency should remain at one percent. In addition, witness Rosenberg questions the gloomy predictions of the Postal Service that it will suffer a loss of \$325.5 million in FY 2000. According to witness Rosenberg, it is highly improbable that the Postal Service will suffer such a loss. Witness Rosenberg reasons that, in order to realize the net loss of \$325.5 million, the Postal Service's net losses for APs 12 and 13 would have to be approximately \$761.5 million. Tr. 41/18307. Since the Postal Service lost

lt should be noted that if a positive income is realized in FY 2000, or losses less than the \$325.5 million projected by witness Patelunas, prior year losses would be reduced accordingly.

only \$212 million in AP 12, (FOS for AP 12.), and projects an AP 13 Operating Budget loss of only \$348 million for AP 13 (\$212 million + \$348 million = \$560 million) (Tr. 21/9219.), it is now exceedingly unlikely that the Postal Service will suffer a net loss as large as \$325.5 million in FY 2000. An additional consideration is that the Postal Service fared better in AP 12 than even its Operating Budget projections—revenues were approximately equal to plan projections for AP 12, but expenses were considerably lower (the Operating Budget projection was for expenses of \$5.0086 billion in AP 12, but actual expenses were \$4.9373 billion). FOS for AP 12. It is to be hoped that the Postal Service's fiscal austerity, self-imposed in the last quarter of FY 2000, continues to be effective.

OCA witness Rosenberg also noted the end-of-year efforts undertaken by Postal Service management to finish FY 00 with a net profit which give credibility to statements by USPS witness Strasser that positive net income can still be achieved. Tr. 41/18307-08. There can be no doubt that this is management's goal. During cross-examination, witness Strasser was asked: "Is the Postal Service taking steps to curb its expenditures at the end of FY2000?" His reply was: "Big time."

Moreover, if the Postal Service does not incur costs at the improbably high level calculated by witness Patelunas for FY 2000, then it is equally unlikely that it will incur expenses in the test year as high as he estimates (since TY 2001 is a roll-forward of costs from FY 2000). This, in turn, should eliminate any projected deficit for

Tr. 46A/20308. These measures are consistent with an exhortation made by the Acting Controller, Donna Peak, in Postal Bulletin 22029, to employees to control discretionary activities and spend money prudently at the end of the fiscal year. Tr. 46A/20308-309.

the test year even if one assumes (as witness Patelunas did) that the Postal Service's rate proposal will not be amended.

In short, the Postal Service has coped well with contingency provisions less than 2.5 percent; the Service is currently enjoying a significantly improved equity position; and the news for FY 2000 is likely to be far better than witness Patelunas' roll-forward would suggest. These factors point directly to the conclusion that the contingency should remain at one percent.

B. The Postal Service Has Failed To Support a 2.5 Percent Contingency

In OCA-T-2, OCA witness Burns reviews past Commission opinions for the purpose of identifying and describing the Commission's framework for evaluating the reasonableness of a proposed contingency. The purpose of the contingency is essentially twofold: it provides a cushion against unforeseeable events⁹¹ and it compensates for forecasting errors.⁹² The factors that are given great weight in the Commission's assessment are "the financial condition of the Postal Service, the state of the economy, [and] the causes of . . . variances." PRC Op. R80-1, ¶0112. Most importantly, the reasoning path of the proponent of the contingency must be "reasonably articulated." In Docket No. R87-1, the Commission established the following principle:

⁹¹ OCA-T-2 at 7 (Tr. 22/9714), citing PRC Op. R80-1, ¶0109.

⁹² *Id.*, *citing* PRC Op. R80-1, ¶0110.

⁹³ Tr. 22/9714, citing PRC Op. R87-1, ¶¶2072-73.

Because the statutory requirement that a contingency be supported by substantial evidence remains in effect, management must . . . provide such evidence, and the Commission must . . . review it. . . . [I]f [unforeseeable] risks are to be the predominant basis of the Postal Service's contingency determination, management's perception of those risks must be articulated to a reasonable degree in order to satisfy the substantial evidence requirement. *Id.*, ¶¶2072-73.

The OCA submits that the Postal Service has not met this standard because it has failed to articulate its reasons for proposing a two and a half fold increase in the contingency. By contrast, OCA witness Rosenberg and DMA witness Buc have clearly and carefully laid out the reasoning process they followed in deciding the appropriate level of the contingency.

 The Postal Service's filed case does not provide rational support for its contingency request

The Postal Service's support for a 2.5 percent contingency was presented in the testimony of the Manager, Budget and Financial Analysis, William Tayman. In a meager two pages, he alluded to a number of vague concerns about the risks the Postal Service might face in the Test Year, without even the faintest trace of the substantiation that should be expected for a request for a \$1.68 billion contingency.

Witness Tayman grumbled that FY 1999 revenues fell short of plan; however, he matched the bad news with some good news—in order to meet its net income goal, the Postal Service engaged in significant cost cutting. USPS-T-9 at 43. As witness Burns observes, managers should not be sheltered too heavily from the effects of future events because they will tend to expend less effort to control costs. OCA-T-2 at 6 (Tr. 22/9713). The Postal Service should be commended for its efforts to cut costs so as to work within its means; however, this should not lead automatically to a higher

contingency. With respect to unexpectedly high Y2K expenses, Mr. Burns remarks that the Postal Service handled the event well with the one percent contingency built into the then-effective rates (*Id.* 9717), still realizing a net income of \$363.4 million in FY 1999. See Exhibit USPS-9L.

Witness Burns also challenged the implication of Mr. Tayman's statements that low volume growth and a planned reduction in workyears are matters outside the Postal Service's control:

[T]he Postal Service controls the rate of workyear reduction. Further, the Postal Service can take measures to control volume . . . by improving service or promoting certain services.⁹⁴

These dim concerns are sounded again in Mr. Tayman's statements that the Internet may be making inroads into transaction, correspondence, advertising and marketing mail volumes. The cited concerns are answered by witness Burns who maintains that the Postal Service "can aggressively meet . . . competition through proper pricing and marketing of competitive services." Witness Rosenberg's contribution to this dialogue bears repeating—a needlessly high contingency exacerbates the slow-growth dilemma and creates a vicious cycle that gives competitors more headroom to compete. 96

Witness Tayman's generalization that "many other uncertainties exist" so lacks content as not to be worthy of challenge. A statement as nebulous as this

⁹⁴ Witness Burns' response to interrogatory USPS/OCA-T2-8 (Tr. 22/9735).

Witness Burns' response to interrogatory USPS/OCA-T2-17 (Tr. 22/9755).

⁹⁶ OCA-T-3 at 29 (Tr. 22/9833).

"does not provide the Commission with any evidence, much less substantial evidence."97

Other nonspecific references to "significant new pressures on salary and benefit cost levels," increasing health benefit costs, and more costly labor contracts are made in the Tayman testimony, but not a single shred of concrete information is provided. Furthermore, forecasts of all of these costs are included in the test year estimates (and for city carriers, aside from future COLA increases, these amounts are known with certainty).

An additional factor that witness Tayman asks the Commission to take account of is the fact that R2000-1 rates will not be implemented until the second quarter of the Test Year. Witness Strasser, on rebuttal, makes the same point. Tr. 46A/20199. This issue has been addressed by the Commission in the past and has been ruled out as justification for a higher contingency.

Discussing the "anticipated revenue shortfall . . . resulting from delayed implementation of rates in the test year," the Commission held in Docket No. R94-1 that:

as a conceptual matter, this anticipated financial development cannot properly be included among the "unforeseen adversities" for which the contingency is intended to provide the Commission agrees with the view[]. . . that "the requested two percent contingency should not be defended, rejected, or modified on grounds of its sufficiency—or

⁹⁷ Tr. 22/9717.

⁹⁸ USPS-T-9 at 44.

insufficiency—to cover losses from the deferment of increased revenues from the proposed rate increase."99

Chairman Gleiman made the same observation in his questioning of witness Tayman:

Witness Tayman: [T]he earliest rates would be implemented would be the second quarter and that is in the contingency, so I imply that, yes, a portion would be consumed by that.

Chairman: That is not an unforeseen event at this point in time, is it?

Witness Tayman: Probably not. 100

Months later, the Chairman took up this issue with witness Strasser:

Witness Strasser: Well, as a matter of practicality, these new rates won't be effective until January, so that will account for upwards of a billion dollars right off the bat because the rates are not implemented October 1st, 2000.

Chairman Gleiman: Who gets to decide when rate cases are filed?

Witness Strasser: The Postal Service.

Chairman Gleiman: And who gets to decide when rate cases go into effect?

Witness Strasser: The Board of Governors.

Chairman Gleiman: Okay. Thank you. 101

The clear implication of the Chairman's questions was that the timing of the submission of the request for higher rates is within the control of the Postal Service and, therefore, would not constitute an unforeseeable, uncontrollable event.

PRC Op. R94-1, ¶2043 (quoting, in part, from the testimony of RDA witness Eden).

¹⁰⁰ Tr. 2/563.

¹⁰¹ Tr. 46A/20400.

Witness Tayman made a vague allusion to competitor efforts to impose legislative limitations on the Postal Service. Addressing this point, witness Burns noted that the Postal Service had endorsed pending legislation that would provide increased flexibility for Postal Service actions. In oral cross-examination, witness Strasser agreed that if H.R. 22 were to be enacted, there would be some benefits for the Postal Service, along with some risks. Tr. 46A/20306. Witness Strasser mentioned another potentially unfavorable piece of legislation involving 20,000 federal employees placed in the wrong retirement system—a correction valued at \$121 million for the entire federal government. Since the Postal Service's 860,000+ workers comprise approximately one-third of the federal civilian workforce, 860,000+ workers comprise Service's exposure under this legislation would be much more than \$40 million. The OCA's proposed one percent contingency (approximately \$670 million) could easily absorb such a charge.

Both Tayman and Strasser overlook an important Commission policy severely limiting the type of legislative change that will given serious consideration in setting the contingency. In Docket No. R84-1, the Commission issued a definitive statement:

[W]e make clear our intention to differentiate between those legislative proposals or initiatives which are clearly speculative either with respect to enactment or with respect to effect on the test year, and those proposals

USPS-T-9 at 44. Witness Strasser made a similar remark concerning "adverse legislation." USPS-RT-1 at 19 (Tr. 46A/20199).

¹⁰³ OCA-T-2 at 12 (Tr. 22/9719).

Commissioner Goldway cited the 1998 Statistical Abstract as the source for her statement that the federal government employs 2.8 million civilian employees. Tr. 46A/20373.

which have been enacted during the pendency of a rate proceeding or those which are substantially certain to be. PRC Op. R84-1, ¶1055.

For example, a bill passed by both houses of Congress, which the Executive has not indicated will be unfavorably acted on, can be said to be substantially likely of passage. On the other hand, pending bills or more legislative proposals do not fall into this category. *Id.*, n. 23.

In light of this policy, it would be inappropriate to enlarge the contingency to protect against the possibility of adverse legislation. Apart from the specific piece of legislation passed by both houses of Congress that has been described above, no other pending legislation seems even remotely likely to be passed in the present Congress, which is now only days away from its final acts. A new Congress will launch its agenda no earlier than the beginning of the next calendar year. In order for legislation enacted by the new Congress to be timely enough to affect the test year, such legislation would have to be enacted by both houses and signed into law by the President within a short time of the new President's and congressional representatives' taking office. Such a chain of events occurring with faultless precision, early in the next calendar year, falls within the realm of mere speculation that the Commission spurned in the passage quoted above.

The foregoing review of the scanty, almost non-existent justification ventured by the Postal Service in support of a \$1.68 billion contingency leads to the inescapable conclusion that the Service has failed to articulate its need for an increase in the contingency to a small degree, let alone a reasonable degree. The Postal Service never comes close to supplying the amount and type of evidence required to meet the substantial evidence test.

2. The Postal Service's rebuttal testimony cannot redeem its failure to justify the contingency request

Revealing a serious miscomprehension about the adequacy of its submission on the contingency in this proceeding, the Postal Service on rebuttal likens the meager testimony of witness Tayman to the information-rich, fully articulated analyses presented by witnesses Rosenberg and Buc. Mr. Strasser testified:

[I]ntervenors have argued that the contingency must be justified largely empirically, with statistics and hard data, such as a historical variance or probability analyses. . . . [I]t seems ironic that each intervenor witness who insists that judgment should not be the basis for determining the contingency has in fact used the very approach he has argued against. Each of them has considered historical data, examined forecasts and trends related to the future, and then judgmentally determined that a lower contingency is warranted based on the facts they have considered. This is the same process the Postal Service followed. Tr. 46A/20183.

Further on in his testimony, Mr. Strasser claims that:

To the extent possible, an "assessment and systematic analysis of the risks that the contingency reserve is expected to protect the Postal Service against" was in fact done. The process was described in the Postal Service's response to OCA Question 2 on the contingency, which I quoted above. *Id.* at 20192.

These claims by witness Strasser are preposterous. The Postal Service has doggedly fought all attempts by the participants to understand the factors considered by the Service in formulating its proposal for a dramatic increase in the contingency. DMA's attempt was rebuffed first, on March 2, 2000.¹⁰⁵ In interrogatory DMA/USPS-T9-36, DMA asked for "any analysis, decision memos, options analyses, briefings, etc.

[&]quot;Objection of United States Postal Service to Interrogatory of the Direct Marketing Association to Witness Tayman (OCA/USPS-T9-36)."

relating to the contingency for this rate case."¹⁰⁶ The Postal Service filed an objection to the interrogatory, claiming that: "Any such documents, other than those filed as part of this case, were predecisional and would therefore fall under the deliberative process privilege."¹⁰⁷ The same objection was raised against OCA interrogatory OCA/USPS-T9-43B, which sought "all documents, notes and analysis performed in determining the level of the contingency for the present docket."¹⁰⁸

As a result of these defensive maneuvers by the Postal Service, the record is utterly devoid of any evidence of a "systematic analysis" that may or may not have been made. Although witness Strasser claimed that analyses were performed, he could not state that any such materials (if, indeed, they do exist) were ever made part of the record and available to the Commission and the parties for their evaluation. Tr. 46A/20281-82. They were not.

Instead, all that the Postal Service has provided in support of its contingency proposal is a short list of subjective considerations underlying the decision to increase the contingency two and a half fold. In response to an OCA interrogatory that framed the request: "Please specifically identify and explain each new or increased concern, risk, issue or other criteria management considered when deciding that the contingency

¹⁰⁶ Filed February 17, 2000.

See Objection cited above.

[&]quot;Objection of United States Postal Service to Interrogatory of the Office of the Consumer Advocate to Witness Tayman (OCA/USPS-T9-43(B))," filed March 24, 2000.

should be increased in this docket from the level requested in Docket No. R97-1," Witness Tayman's reply was: "The determination was largely subjective." 109

He gave a similar reply to a DMA interrogatory that questioned him about a sentence in his testimony that: "The Postal Service's financial performance is under much greater pressure and is subject to substantially greater risks than it was at the time of the last two omnibus rate cases." The question asked was: "Did you perform any studies which quantified 'greater pressure' or 'greater risks?' Please list all factors with respect to which the Postal Service is under 'greater pressure' or 'subject to substantially greater risks." He replied that: "The statement is subjective and intuitive."

3. Subjective determinations cannot support a large increase in the contingency

While postal management's subjective determinations are given some deference, a Postal Service justification resting almost entirely on subjective determinations and intuition is utterly inadequate to support an increase in the contingency of this magnitude. The Postal Service should have performed the kind of "systematic analysis" cited in witness Burns' testimony. Tr. 22/9709.

The Commission's opinion in Docket No. R87-1 contains a clear statement of the Commission's doctrine for proper support for a contingency proposal:

¹⁰⁹ Interrogatory OCA/USPS-T9-43(c) (Tr. 2/385).

¹¹⁰ Interrogatory DMA/USPS-T9-47 (Tr. 2/304).

- Subjective judgement must be blended with objective judgment concerning forecast errors and their sources.¹¹¹
- ♦ Subjective judgment must be articulated. Id.
- ♦ Objective judgment must be subjected to statistical analysis. Id.
- ◆ The set of events from which intuitively-sensed risks are drawn must be articulated.¹¹²
- ♦ The role of past experience in influencing the sensed magnitude and likelihood of the unforeseen risk must also be articulated. *Id*.
- ♦ There should be an indication of the importance of unforeseeable risks relative to recognized-but-unquantifiable factors. *Id.*

The Postal Service's filing in the instant proceeding fails all of these tests.

First, there was no objective information presented other than the requisite variance analysis; and Mr. Tayman rejected making the variance analysis the basis for his decision:

I believe historical variance analyses should not be the basis for determining the need for a contingency or its size. . . . No matter what results an historical variance analysis produces, it is not appropriate to use historical data to determine the size of the contingency in lieu of management's judgement about the future.

These calculations are included for informational purposes only. To conclude from any historical variance analysis that a certain level of unforeseen events will occur in the Test Year would be both irresponsible and illogical. USPS-T-9 at 45.

Needless to say, there was not a particle of other objective information cited and relied upon by witness Tayman. The Postal Service has rich stores of information

¹¹¹ PRC Op. R87-1, ¶2077.

¹¹² Id. at ¶2073.

available to it, giving it the capability to base its determination on analytical and statistical tools that incorporate the information. Witness Burns described the kinds of analyses performed by insurance companies to justify contingent or catastrophic reserves.¹¹³

The criticism of witness Burns' invocation of practices followed in the insurance industry betrays a profound misunderstanding of the Burns example. Witness Strasser's comment that the 13 to 18 percent level of insurance reserves exceed the proposed 2.5 percent contingency by more than five times shows that Strasser has missed the point. Witness Burns had, in response to a Postal Service interrogatory, cautioned that:

one would expect a reasonable contingency reserve for an insurance company to be much larger than what would be a reasonable contingency reserve for the Postal Service. My discussion of the contingency reserves established by the insurance industry was not for the purpose of saying that the *size* of insurance reserves was in any way analogous to the size of appropriate Postal Service reserves. Rather, I cited the insurance industry as a model of the *method* that the Postal Service should use to determine accurately the size of its needed contingency reserve. The uncertainties associated with any particular industry and its ability to control costs and revenues are unique to each industry.¹¹⁵

Witness Burns also testified that insurance regulators will not permit the reserve to be used improperly, *i.e.*, to smooth out irregularities or volatility in earnings. Tr. 22/9711. The Commission shares this view. In a stern criticism of rebuttal testimony

¹¹³ Tr. 22/9710-13. See also Tr. 22/9726-29.

lronically, both witnesses Strasser and Zarnowitz describe the purpose of the contingency as "insurance." See, e.g., Tr. 46A/20239, 20350 and 20399; and Tr. 41/18212-13 and 183239.

Response to interrogatory USPS/OCA-T2-3 (Tr. 22/9727).

presented by Postal Service witness Porras in Docket No. R97-1, the Commission held:¹¹⁶

[W]itness Porras seems to be suggesting the 1.5 percent contingency only in order to counterbalance the reduced expenses he identifies. This suggests that the contingency is simply a plug figure used to justify a predetermined revenue total.

The Statute requires that the revenue requirement include a "reasonable provision for contingencies." 39 U.S.C. § 3621. This requires that the amount be reasoned. . . . Arguments attempting to justify an arbitrary amount will not be accorded much weight. The Postal Service's conservative estimates of its 1998 surplus militate against increasing the contingency. Consequently, the Commission will reject the suggestion of a 1.5 percent contingency.

The description given by the Postal Service of the fluidity in the process followed in this proceeding to determine the size of the contingency suggests that, once again, the \$1.68 billion requested is a "plug figure used to justify a predetermined revenue total." In response to OCA question (no. 1) on the contingency, the Postal Service related the following:

At the level of the Board of Governors' decision to approve a particular rate filing, the contingency amount reflects a fundamental policy judgment regarding the level of risk that can be tolerated in estimates of future expenses and other revenue needs. In this regard, the contingency is assessed in relation to the elements of the entire revenue requirement, as well as to an array of financial and other policy considerations. While the contingency amount is grounded in a subjective assessment of future uncertainties affecting the Postal Service's estimates, the determination of its reasonableness is considered by the Board in the context of all of the Postal Service's proposals, including the overall impact of the rate and fee changes, as explained in witness Tayman's testimony.¹¹⁷

¹¹⁶ PRC OP. R97-1, ¶¶2030-31.

[&]quot;Response of United States Postal Service to Questions of the Office of the Consumer Advocate Regarding the Provision for Contingencies," filed May 17, 2000, at unnumbered page 2.

The Service added, in answer to question no. 2, that:

The overall sense of risk that emerges from this evaluation is balanced subjectively against the other elements of the Postal Service's proposals and policy choices, such as the impact of rate increases on customers and the Board's policy regarding equity restoration.¹¹⁸

It is evident from this account that the Postal Service does not attempt in any manner to relate the level of the contingency to specific types of risks, with an allied effort to measure them. Just as the Postal Service's R97-1 contingency figure was a "plug," not reasoned, and "arbitrary," the Postal Service's subjective, intuitive presentation in this proceeding suffers from the same defects.

The second tenet of the policy enunciated in Docket No. R87-1 was that subjective judgment must be articulated. The OCA submits that the scant two pages contained in witness Tayman's testimony falls woefully short of the necessary explanation. The fourth and fifth tenets have not been met for the same reason.

The Postal Service has obviously failed the fourth test since it presented no objective information, apart from the required variance analysis. This, as discussed above, was disregarded by witness Tayman.

There was no attempt made to satisfy the fifth tenet, which would appear to be a rough indication about what portion of the contingency was due to known, but unquantified risks, and what portion due to unforeseeable events.

¹¹⁸ Id. at unnumbered page 4.

During witness Strasser's appearance, several Commissioners expressed their frustration at having so little evidence from the Postal Service on which to base a decision about the contingency. For example, Commissioner Goldway admonished:

It seems to me that the contingency, if it is going to be a contingency, that it's not used with moral hazard but used for real purpose, you would have to identify the kinds of reasons you needed the contingency and measure yourself against them year after year to say what a contingency is needed for.

Have you ever listed those unknowns to determine what they are each year and how much on average they would cost? Tr. 46A/20368.

Witness Strasser replied: "No, we have not done that."

Later, Commissioner Goldway characterized the Postal Service's contingency determination as "really sloppy." *Id.* at 20369. The Postal Service's refusal to account for its past uses for the contingency is sloppy; it prefers to keep the Commission in the dark about how contingencies are used. This frustration was the focus for Commissioner Goldway's further comment that:

we don't know what happens to that 2.5 percent at the end of the year, whether you have kept it as a contingency or not, so that we know in future years—you don't keep track of it and we are not given the information to determine whether that is really needed to break even or not. *Id.* at 20371.

Chairman Gleiman indicated in remarks to witness Strasser that postal customers would appreciate more candor on the part of postal management about the need for a contingency of this size:

my point is that your customers are saying that they think you're putting too much money aside and that if you do need to do things that aren't within the list of the first nine plagues, if you don't have to cover costs associated with events like the first nine plagues, that they would just as soon have you talk to them later and be more straightforward about what

your needs are in terms of building buildings or whatever else it is you want to do with that money *Id.* at 20399.

4. <u>2.5 percent lies outside of the bounds of variance analysis</u>

Having explicitly declared that variance analyses should not be the basis for the size of the contingency (USPS-T-9 at 45), witness Tayman went on to propose a contingency of 2.5 percent, which was outside the range of all of the variance analyses he included in his Exh. USPS-9J. The variance analyses yielded results ranging from a positive 2.2 percent to a negative 2.3 percent, with a midpoint close to zero. Tr. 22/9822. Witness Rosenberg compared total actual and estimated revenues and expenses for R87-1, R90-1, R94-1, and R97-1 – and found that on average the Postal Service underestimated net income by 1.57 percent of total estimated costs. Furthermore, the Postal Service incurred a net loss in only one of the four actual test years. The 1.57 percent, of course, is much closer to the OCA's proposed one percent contingency than the Postal Service's 2.5 percent proposal.

The Postal Service insists that the risk associated with "unknown unknowns" cannot be measured, losing sight of the fact that variance analyses are a rich source of information on how large the "unknown unknowns" have been over time. This benefit of variance analyses was cited explicitly by the Commission in PRC Op. R80-1: "Proper variance analysis contemplates that historical results will provide an insight into the future." In Docket No. R87-1, the Commission reiterated this view:

We maintain [that] ... forecasting errors have sources, and that much can be learned by systematically evaluating the behavior of those sources

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¹¹⁹ PRC Op. R80-1, ¶0115.

over time. We also adhere to our view expressed in Docket No. R77-1 that the relative magnitude of unforeseen events, including external events, over the long run will tend to display a degree of predictability, based upon historical results. 120

The Commission frequently relies on the statistical results produced by variance analyses (PRC Op. R94-1, ¶2040), choosing a contingency allowance that is within the variance range. The OCA urges the Commission to do so again in this case and reject the Postal Service's 2.5 percent proposal which falls outside the range of variance analyses contained in witness Tayman's testimony.

III. VOLUME VARIABILITY SHOULD REMAIN AT 100 PERCENT

A. Overview

The Postal Service is again introducing a new method for calculating the volume variability of several MODS cost pools, components of mail processing costs, through its witness A. Thomas Bozzo (USPS-T-15 and USPS-RT-6¹²¹). An essentially similar methodology advocated by Postal Service witness Michael D. Bradley and opposed by OCA witness J. Edward Smith was rejected by the Commission in Docket No. R97-1, and the Commission remained with its traditional 100 percent volume variability. In this proceeding, OCA witness Smith (OCA-T-4) testifies that the new methodology continues to be deficient and again recommends its rejection.

PRC Op. R87-1, ¶2077.

Postal Service testimony on this subject was also filed by Degen (USPS-T-16) and (USPS-RT-5), Tr. 38/17307-54 and Greene (USPS-RT-7), Tr. 46E/22036-73.

Testimony in support of the Postal Service position was submitted from a group¹²² that presented three witnesses: MPA witnesses Cohen (MPA-T-1) and Elliott (MPA-ST-2) and Time Warner, Inc. witness Stralberg (TW-RT-1). Testimony in opposition to the Postal Service position was filed by United Parcel Service witness Neels (UPS-T-1).

The following econometrically estimated variabilities of witnesses Bradley's testimony from Docket No. R97-1 and Bozzo's testimony in this proceeding were presented by witness Smith in Table 2.123

Table 2
Mail Processing Activity

	Variabilities <u>Dr. Bradley</u>	Variabilities <u>Dr. Bozzo</u>	Total Cost <u>\$000</u>	Attributable Cost per Dr. Bradley \$000	Attributable Cost per Dr. Bozzo \$000
BCS Sorting	0.945	0.895	1,043,841	986,430	934,238
OCR Sorting	0.786	0.751	219,070	172,189	164,522
FSM Sorting	0.918	0.817	1,042,369	956,895	851,615
LSM	0.905	0.954	78,765	71,282	75,142
SPBS Non Priority	0.469	0.641	283,275	132,856	181,579
SPBS Priority	0.802	0.641	82,447	66,122	52,849
Manual Flats	0.866	0.772	459,933	398,302	355,068
Manual Letters	0.797	0.735	1,563,963	1,246,479	1,149,513
Manual Parcels	0.395	0.522	60,593	23,934	31,630
Manl. Priority Mail Srtg	0.448	0.522	259,762	116,373	135,596
Cancel. And Mail Prep.	0.654	0.549	295,957	193,556	162,480
Subtotal			5,389,975	4,364,418	4,094,231
Composite Variability				0.81	0.76

A general overview of the complex volume variability issue, would be useful.

The fundamental question is how much does the Postal Service's labor cost for a

Including Alliance of Nonprofit Mailers, American Business Media, Coalition of Religious Press Associations, Dow Jones & Company, Inc., The McGraw-Hill Companies, Inc., National Newspaper Association, and Time Warner Inc.

particular mail processing activity change (as a percentage) for each unit percentage change in the volume of mail processed. This is the volume variability. Currently, the Commission assumes that, for each piece of mail processed, the cost of labor increases proportionately; this is known as 100 percent volume variability. For several of its different mail processing labor activities, labeled as MODS cost pools, the Postal Service proposes a new method to calculate the percentage change in labor hours for a percentage change in mail volume. The percentage obtained (the variability of cost) is then applied to the labor costs of the cost pool to determine the portion of total cost that is volume variable labor cost for that cost pool. The labor costs are then distributed to each of the classes of mail in accordance with the estimates of the relative volume of each class and subclass of mail processed.

The issue of volume variability of mail processing is strenuously debated on this record by several economists. The witnesses offer at least four separate primary alternative methodological approaches to the Commission, each with several possible permutations. The objective is to establish a mathematical equation which best represents the relationship of labor costs to mail volume. If that model is correct, then the regression analysis will yield an estimate of the volume variability. This is not accomplished without controversy; for every suggestion of method there is a counter suggestion. The data, the assumptions and variables in the equation representing the model, the regression method, and the statistical tests all present potential pitfalls.

Tr. 27/13157. Table 2 (Table 1 in OCA-T-4) does not include minor corrections to witness Bozzo's testimony which witness Smith viewed as *de minimis*. See Tr. 27/13156, note 8.

These issues must be resolved to decide whether the mail processing volume variability is actually different or sufficiently different from the traditional 100 percent volume variability to justify both accepting the new methodology and pinpointing the appropriate variability percentage to apply to individual cost pools.

The decisional starting point is one of the few points on which all parties agree: the Commission has traditionally applied a 100 percent volume variability to mail processing costs, and, most recently, the Commission has applied virtually a 100 percent variability to the MODS (and non-MODS) cost pools. MODS cost pools were first presented by the Postal Service in Docket No. R97-1.

The source of the 100 percent volume variability tradition is usefully recounted in witness Bozzo's testimony. However, the conclusions reached from that history vary. Some would say it proves that the 100 percent tradition is without foundation; others, such as the OCA, contend that a careful reading indicates the intuitive logic of the 100 percent tradition in the face of unsatisfactory quantitative variability analyses. The Commission should first consider the lessons of history as a guide to the type of justification necessary to warrant any change from its traditional approach.

The Postal Service, as an advocate of change in its methodology, has the burden of proof.¹²⁴ This burden is substantial, and the Commission's Opinion in Docket No. R97-1 rejecting the Postal Service methodology demonstrates the significance of this burden. The Postal Service experts generally claim that the fixed effects model it

See pages 12-14, *supra*. The burden of proof also falls on MPA witness Cohen, who supports witness Bozzo, in part, but who seeks further modification of the existing methodology.

has constructed properly measures the impact of mail volume on mail processing labor costs. They support this with favorable statistical tests. Another party, MPA, even suggests applying the model to additional cost pools, including non-MODS cost pools, related to allied labor even though the Postal Service itself declined to apply the model's results so broadly.

The OCA and the UPS expert witnesses, however, are not so impressed with the Postal Service's presentation. As complex and impressive as the fixed effects variabilities appear statistically, the results are not proven; further examination of the study shows that it is based on very questionable hypotheses. First, OCA witness Smith, in particular, contends that the regression model of the Postal Service is not based upon a proper theoretical foundation as required by economic principles. The model is, after all, measuring costs, and in economic theory the starting point for measuring costs requires a correctly specified cost or labor function to measure the processes under consideration, neither of which have been substantiated by the Postal Service. This means that even if the model passes the statistical tests it is irrelevant. because the model has not been shown to be measuring the correct characteristics that either affect, or have an effect, upon the labor demand. OCA witness Smith also applies this fundamental conclusion rejecting the Postal Service model to other models considered in this record. He applies it to the one considered in an NOI request, and to other related models called the pooled, random effects, and "between" models because, in the end, they all rely upon the same unsatisfactory theoretical model developed by witness Bozzo.

Second, even if one attempts to utilize witness Bozzo's model, the OCA and UPS experts contend that the characteristics measured by the model are probably measured incorrectly. For instance, OCA and UPS experts have testified that the underlying data are error prone, perhaps because there are not adequate data collection and verification procedures. The Postal Service counters that the errors are minor, but neither the OCA nor the UPS witnesses are convinced.

OCA witness Smith contends the Postal Service erroneously assumes that certain factors do not affect the volume of mail processed. He faults the model since those factors are not taken into account either in the initial assumptions establishing the model or in the selection of important variables. The OCA expert also contends that some of the variables (for instance, the capital variable) do not adequately measure what they are supposed to measure. The Postal Service says they have done their best, and in any event any additional adjustments would not have a significant effect on the result. Notably, they recognize that at least some change to their results would occur if certain objections were correctly addressed, even if the changes do not increase the variabilities to as much as 100 percent.

OCA witness Smith also contends with conviction that the Postal Service model measures changes over the short run. This results in a quite different regression line and one which provides a lower volume variability than the more steeply sloped longer-run expansion path advocated by witness Smith that indicates a volume variability close to 100 percent.

The UPS demonstrates with substantial statistical support that, if witness Bozzo's model is recomputed after correcting for the relationship between piece

handlings and first handled pieces, the variabilities are closer to the traditional 100 percent volume variability. In some cases they are actually greater than 100 percent. As may be expected, the Postal Service witnesses refute the UPS technique and results.

Third, OCA witness Smith views the entire matter as one that can best be resolved with a working group to look more carefully at the underlying cost functions and appropriate models. There are many fundamental issues that need to be resolved before any model is applied to determine the volume variability. For instance, the OCA and the UPS witnesses testify that the entire model may in fact be measuring the wrong amount of mail. That is, should the measure of the change in the cost of labor be based upon the number of separate pieces of mail processed, or should that number also include a count for the number of times each individual piece is sorted a second or third time?

Another fundamental issue is the appropriate form of the model selected, particularly the variables chosen. OCA witness Smith does not rule out any particular method of calculating the variability, including the fixed effects approach used by the Postal Service, but only if it is first properly specified (*i.e.* includes the correct variables in the correct relationships); the OCA contends that is far from being accomplished.

The Commission is faced with at least four primary alternatives, all of which are championed with some evidentiary support: (1) reject the proposals as the Commission did in Docket No. R97-1 as unproven and insufficient; (2) accept the Postal Service recommendation to modify the variabilities for certain cost pools; (3) accept the Postal Service recommendation and apply it even further to other cost pools in allied

operations; or (4) apply one of the various alternative variabilities offered by the OCA or the UPS for the cost pools. The Commission could additionally seek information for a final resolution based on information developed in a working group constituted between rate cases.

A further significant issue arises if the Commission chooses to apply now a model: which variabilities to apply from the various estimates for each of the cost pools in this record. Given the numerous choices advocated by the witnesses and the uncertainty as to the appropriateness of any particular model, unless the choice of model and its methodology are clear, the Commission should remain with the *status quo* pending further study of the issue and better understanding of the appropriate model.

Significantly, the Commission in the Opinion in Docket No. R97-1 explicitly and soundly rejected a model very similar to the one offered by the Postal Service in this case. The following argument analyzes the Postal Service's case, generally following the analytical format followed by the Commission in its Opinion in Docket No. R97-1. Analysis indicates that the current Postal Service model is fundamentally like the model presented in Docket No. R97-1, with only a few adjustments. Further, the adjustments to meet the Commission's extensive objections to its model are inadequate. Consequently, the Postal Service model must be again rejected by the Commission, and a working group to study the matter more fully should be established.

B. The Determination of Volume Variability for Certain Mail Processing MODS Cost Pools Significantly Affects Variable Costs

Volume variability is an important issue, for segment 3 mail processing costs are in excess of \$17 billion, consisting of processing costs at MODS offices of \$12.5 billion, at BMC's of \$0.8 billion, and at non-MODS offices of \$4.4 billion. Tr. 27/13154. The variabilities applied to the various cost pool costs associated with the activity are used to yield a measure of attributable costs. Segment 3 costs that are not attributable become institutional, requiring the Commission to recommend assignment of the costs to various rates, classes and categories. Tr. 27/13150.

The Commission recognized in Docket No. R97-1 the significance of the Postal Service proposal to modify the mail processing variabilities, which would have reduced attributable costs by more than \$3 billion. The Commission stated, "Such a large transfer between cost pools is bound to influence the rates recommended by this Commission." PRC Op. R97-1 at 63.

In Docket No. R97-1, the Postal Service sought to reduce significantly the volume variability for all of the mail processing costs in 45 MODS cost pools plus several non-MODS cost pools it had established. The Commission rejected the request to move away from the traditional 100 percent variability. In this Docket, R2000-1, the Postal Service only estimates the volume variability for 10 mail processing activities. Tr. 27/13150. It also has dropped the request to apply the variabilities, by proxy, to the non-MODS operations. USPS-T-15 at 134. Witness Bozzo has measured the volume variabilities of mail processing activities for 10 MODS cost pools and found variabilities ranging from 52 percent to 95 percent. Tr. 27/13150.

By rejecting witness Bozzo's variabilities, witness Smith proposed changing several of witness Bozzo's MODS variabilities used by USPS witness Van-Ty-Smith (USPS-T-17). Specifically, witness Smith proposed changing the following MODS pools variabilities to 100 percent: BCS, OCR, FSM, LSM, SPBS OTH, SPBSPRIO, MANF, MANL, MANP, PRIORITY, and 1CANCMPP. Some measure of the impact of witness Smith's testimony is shown in the testimony of OCA witness Thompson (OCA-T-9, Appendix B, Exhibits 2A and 2B). Final results of the impact of the testimonies of OCA witnesses Smith and Ewen and USPS corrections with USPS PESSA costs are shown in witness Thompson's Exhibit 3C, "USPS and OCA Comparisons of Test Year w/PESSA (\$000)." Tr. 23/10432. The combined impact of witnesses Smith's and Ewen's proposals increases attribution of total volume variable costs by approximately \$2.3 billion and, correspondingly, lowers institutional costs by approximately \$2.3 billion.

C. "Déjà vu all over again" — a Rerun of Docket No. R97-1 Issues and Errors 126

The Postal Service's volume variability presentation is essentially a rerun of the original volume variability study rejected by the Commission in Docket No. R97-1.

See USPS-T-17, "Table 1: Cost Segment 3 Clerk and Mailhandler Cost Pools – Part 1 of 2" at 24.

This is a well-known quote attributed to Yogi Berra who, when not being quoted, played some baseball with the New York Yankees and who had a certain amount of relevant expertise in this area. He demonstrably knew with intuition and common sense how to estimate faster than an econometrician, using all relevant variables, the best fit of data to determine the direction and slope of an object moving through time and space. We suspect, but hesitate to suggest, that he often selected the "visually compelling" line.

1. A summary of Docket No. R97-1 findings regarding witness Bradley's errors, many of which apply to witness Bozzo's study

Because the foundation of the Postal Service case is in many respects a rerun of the fixed effects model rejected by the Commission in Docket No. R97-1, it is instructive to first summarize the Commission's findings in Docket No. R97-1. The Commission Opinion rejected the Postal Service's model in several broad areas that related to time period of the data, error-ridden samples and problems with scrubbing of the data, control variables treated as non-volume variables when they are volume variable, and several unsupported assumptions regarding the mail processing operations.

Specifically, the Commission found the following errors in the model. The focus was on four week accounting periods which, as applied, effectively covered an eight week time span — too short to capture effects that are volume variable over the time span of a postal rate cycle. The Commission also found the underlying database was bad. PRC Op. R97-1, at 81. If there is measurement error in piece handlings, the estimates will tend to understate the true volume variability of mail processing costs. PRC Op. R97-1, at 83. The Commission also viewed witness Bradley's data scrubbing as ineffective. PRC Op. R97-1, at 84.

Witness Bradley's controls (terms) in his cost equation were inadequate and, contrary to his assumptions, they were volume variable (rather than fixed). PRC Op. R97-1, at 85. Control variables are needed that explain costs in ways that are statistically effective and accord with economic theory, but are not themselves volume variable over the time spanned by the cost equations. *Id.* The Commission also found

witness Bradley's equations had fixed effects that are volume variable, and not based on correctly specified cost functions. *Id*.

The Commission cited as a basis for rejecting the model other untested assumptions that witness Bradley's model assumed: the proportionality of subclass volumes; that average postal wage rates do not change in response to sustained changes in postal volumes; that mail processing time is unaffected by piece handlings at other activities; that the number of mail processing facilities and capacity of the existing ones is not volume variable; and that the slope coefficients are the same at every facility. PRC Op. R97-1, at 89-91. The Commission concluded, "the defects in witness Bradley's research lead him to underestimate volume-variabilities for mail processing labor costs." PRC Op. R97-1, at 67. Also, "Bradley's estimates fail to represent all of the likely sources of volume-variability, particularly at the facility and system levels." PRC Op. R97-1, at 67.

The Commission elaborated on its objections in Appendix F to the Opinion. The Commission stated that it would prefer to rely upon a model that complies with economic theory, fits by accepted econometric methods, and statistically explains all relevant data. The Commission concluded, "Unfortunately, no such model for mail processing labor costs appears within the testimony of any witness in the current proceeding." PRC Op. R97-1, at 70. Moreover, the Commission stated that it "would be willing to rely upon [statistical] tests if witness Bradley's testimony satisfied common and accepted standards for econometric practice. However, it is the Commission's opinion that it does not." PRC Op. R97-1, at 79. The Commission concluded that econometrically regressing processing times on total piece handlings and a collection of

controls without consideration of the underlying economic theory may yield a very inaccurate characterization of the true relationship of cost to volumes. On the other hand, specifying a cost model derived from economic theory without regard to the actual data it is attempting to explain is also likely to lead to inaccurate estimates of the true relationship. PRC Op. R97-1, at 70.

2. A summary of witness Bozzo's study, which includes many of the errors the Commission found in the Docket No. R97-1 study

Virtually all of the conclusions reached by the Commission in Opinion No. R97-1 regarding witness Bradley's model, continue to apply to this record. Despite witness Bozzo's alterations to parts of witness Bradley's previous presentation, including the addition of a capital variable that the OCA witness believes is deficient, the Postal Service's presentation in this case continues to contain many of the flaws previously recognized by the Commission. Therefore, the issue of volume variability of mail processing, the analysis, and the conclusion with respect to Docket No. R97-1 are essentially $d\acute{e}j\grave{a}vu$.

Both witness Bradley and witness Bozzo measured costs in terms of labor hours of segment 3 mail processing effort. Witness Bradley measured volume in terms of total pieces handled (TPH), and witness Bozzo measured volume in terms of total pieces fed (TPF) or in some cases total pieces handled (TPH). Tr. 27/13153.

Estimation procedures can include a variety of econometric models. Witness Bozzo's choice of the fixed effects model is a follow-on work to witness Bradley's study, and many of the problems associated with the original study continue to be found in the revised study. Tr. 27/13152.

The deficiencies of witness Bradley's scrubbing process generally focused on the elimination of relevant data. Tr. 27/13163. As to witness Bozzo's study, witness Smith has stated, "There is less data scrubbing, but the rules for the data scrubbing are not significantly better. There was apparently no discussion with field based personnel of the data on a site by site basis for data items suspect (unless required to answer an interrogatory)." Tr. 27/13166.

Although witness Bozzo's model is now quarterly, it is nevertheless a short-run model. Accordingly, the Commission's criticism continues to be relevant. The usual economic definition of long-run costs is that they are the costs when all inputs are variable. If some inputs are variable, but others are not, then costs are short run. However, there are many flavors of short run depending upon what inputs can be verified over the length of time considered. PRC Op. R97-1, at 80. The Commission found that witness Bradley's study was short run; this is also the case for witness Bozzo's study. Witness Smith concludes that the Postal Service model remains short run, a characteristic strongly criticized by the Commission in Docket No. R97-1. Witness Smith testified, "Dr. Bozzo's approach continues the short-run approach to estimation." Tr. 27/13167. Witness Bozzo has modified the data to a quarterly basis, but the analysis is still based on short-run costs. Measuring changes in cost with respect to volume, but not adequately addressing issues of capacity utilization and investment, can have a significant impact on longer-run costs through the effects of facility expansion. Tr. 27/13168. The expansion path is the hyperplane that should be measured, not the short run hours/TPF relationship. Tr. 27/13167.

Witness Bozzo has again used the fixed effects estimating procedure. Tr. 27/13165. Witness Bradley indicated in Docket No. R97-1 that his experience studying mail-processing activities strongly suggested there were significant non-volume variations across facilities as indicated by a Gauss-Newton Regression. The fixed effects approach attempts to capture differences between facilities not captured by the variables in the equations, as measured by the intercept. However, the approach works only in measuring fixed effects at a site when the fixed effects never change. Tr. 27/13164. Witness Smith stated: "The econometric methodology continues to be fixed effects, even though the major deficiencies of this approach were discussed in detail in the previous case." Tr. 27/13168.

Witness Smith also testified to other deficiencies in witness Bozzo's model, "There has been some introduction of additional variables, for example, the consideration of networks. However, a potentially key variable—capacity utilization—is missing. The previously discredited manual ratio continues to be used." Tr. 27/13168. Also, as to witness Bozzo's study, witness Smith stated, "There appears to be a number of theoretical errors. This is not a trivial issue. The treatment of capital could potentially have a significant effect on the conclusions. . . ." Tr. 27/13168.

The Postal Service model continues to rely upon the series of assumptions the Commission found to be untested in its Opinion in Docket No. R97-1: average postal wage rates do not change in response to sustained changes in postal volumes; mail

This is a key point. Other testimony disagrees with some of the findings, and this has a key impact on conclusions that should be drawn. Witness Bozzo also used a fixed effects approach. He has provided inadequate explanation and response to the Commission's comments on fixed effects.

processing time is unaffected by piece handlings at other activities; the number of mail processing facilities and capacity of the existing ones are not volume variable; and the slope coefficients are the same at every facility.

To repeat, the issue of mail processing variability is déjà vu all over again.

D. The Burden of Proof Is on the Postal Service To Justify a Change in the Commission's Method for Determining Mail Processing Cost Variability

The burden of proof was discussed generally at the outset of this Initial Brief. Because of the importance of the burden of proof to the Postal Service's proposed change in the volume variability methodology some further discussion is warranted here.

In rejecting the Postal Service's volume variability proposal in Docket No. R97-1, the Commission recognized the Postal Service's initial burden to justify its position and the consequences of failing to meet that burden:

The established assumption that most mail processing costs are 100 percent volume-variable has not been proven to be incorrect by the evidence given by witness Bradley and others in this proceeding. Therefore, the Commission continues to regard most mail processing labor costs as approximately 100 percent volume-variable and has attributed these costs to the subclasses and special services accordingly. PRC Op. R97-1, at 65.

In ratemaking proceedings, the Postal Service, seeking adjustments to the rate structure, is the proponent of change. 39 U.S.C. § 3622(a). The Administrative Procedure Act states that "[e]xcept as statutes otherwise provide, the proponent of a rule or order shall have the burden of proof." USPS-T-15 at 5-13. Having the burden of proof establishes very specific requirements for the Postal Service's evidence and the

criteria against which that evidence is to be measured. The general evidentiary rule is that "the party who has the burden of pleading a fact will have the burdens of producing evidence and of persuading the jury of its existence as well." The McCormick treatise on evidence notes that the "burdens of pleading and proof with regard to most facts have been and should be assigned to the plaintiff who generally seeks to change the present state of affairs" Id. at 428.

When a participant proposes to make a change in an existing and approved methodology underlying postal rates, it bears a two-fold burden. First the participant must prove by substantial evidence that the existing methodology is no longer reasonable and equitable, and then the proponent must also prove that the proposed change will result in reasonable and equitable rates under 39 U.S.C. § 3621. This differs from the situation where the Postal Service submits new cost information simply to generate new rates through the existing rate determination methodology.

The two-fold burden when dealing with proposed changes in existing rate determination methodology was explained by the Federal Energy Regulatory Commission in ANR Pipeline Co., FERC ¶ 61,263 at 61,735 (1986):

In performing a proper analysis of the issues of cost classification, allocation, and rate design, applicable legal precedent requires a two-pronged inquiry: (1) is the existing rate design . . . unjust and unreasonable; and (2) will the proposed change result in just and reasonable rates. . . .

The "just and reasonable" standard of the Natural Gas Act, 15 U.S.C. §717c, is comparable to the "reasonable and equitable" standard of the Postal Reorganization

McCormick on Evidence (4th ed. 1992), at 427 (citations omitted).

Act, 39 U.S.C. § 3621. The requirement to find that existing methodologies are not longer reasonable and equitable before considering whether the proposed change would result in reasonable and equitable rates is also consistent with judicial precedent.¹²⁹

In order to support its position, then, the Postal Service must first provide qualitative, credible evidence that the existing 100 percent volume variability method is no longer valid. The Postal Service has failed to meet this standard. The Postal Service has indicated that the previous 100 percent methodology used by the Commission was used mainly as a matter of convenience after the failure of several efforts to derive variabilities using quantitative methods. USPS-T-15 at 5-13. It is clear that to overturn an agency practice the proponent bears the burden of persuasion that the present policy is not as favorable as the one offered. The underlying reasoning for the present policy is not at issue. The 100 percent mail processing cost volume variability policy has been approved several times by the Commission. The Commission made clear in Docket No. R97-1 that those who would overturn that policy bear the burden to justify the rejection of a previously accepted policy. PRC Op. R97-1, at 65.

See, e.g., Northwest Pipeline Corp. v. FERC, 61 F.3d 1479, 1488 (10th Cir. 1995); Tennessee Gas Pipeline Co. v. FERC, 860 F.2d 446, 456 (D.C. Cir. 1988); Sea Robin Pipeline Co. v. FERC, 795 F.2d 182, 186-87 (D.C. Cir. 1986); and ANR Pipeline Co. v. FERC, 771 F. 2d 507, 513-14 D.C. Cir. 1985). The standards expressed under Section 5 of the Natural Gas Act, 15 U.S.C. § 717d, are applicable here because no rates can be implemented under 39 U.S.C. § 3621 until the Commission and the Board of Governors have issued decisions on a rate change request made pursuant to 39 U.S.C. § 3622.

See, for example, PRC Ops. Docket Nos. R97-1, R94-1, R90-1, R87-1 and R84-1.

It is also the Postal Service's burden to demonstrate that its preferred volume variability method attributes mail processing costs to the appropriate classes and, thereby, results in fair and equitable rates. However, the Postal Service has not adequately demonstrated that its methodology, or any of the other methodologies offered, provides a reasonable calculation of the actual variability for the individual MODS pools. There are several variabilities for each cost pool offered on this record. As part of the Commission's consideration of this issue, the Commission must consider whether, if it attempts to move away from the present policy, it is able on this record to select variabilities for each of the MODS pools that approximate with reasonable assurance actual variabilities. The prerequisite for any methodology is that the costs it attributes to a given class be reliably identifiable with that class. If the costs attributed are not first reliably identified with a particular class under the methodology applied, then the Postal Service methodology does not meet the requirements of the Act.

The Supreme Court has set the standard on the cost attribution issue:

The Act does not dictate or exclude the use of any method of attributing costs, but requires that all costs *reliably identifiable* with a given class, by whatever method, be attributed to that class. (Emphasis supplied.)¹³¹

The test for determining whether attributed costs are reliably identified with a particular class is whether those costs are "demonstrably related" to the class of service in question. *Id.* at 824. The Supreme Court has looked favorably on this Commission's

National Association of Greeting Card Publishers v. U. S. Postal Service, 462 U.S. 810, 820 (1983).

holdings that the Act requires "a sufficient causal nexus" before costs may be attributed. 132 Legislative history supports the view that:

when causal analysis is limited by insufficient data, the . . . Commission will "press for . . . better data," rather than construct an "attribution" based on unsupported inferences of causation. PRC Op. R74-1 at 110-111. 133

It is OCA's contention that the various fundamental and significant questions raised with respect to witness Bozzo's methodology demonstrate that it does not reliably identify costs for attribution (nor, for that matter, does any other methodology applied in this record). Lacking a demonstrably causal connection as a result of the insufficient methodology, the Postal Service has failed to meet its burden of proof and the Commission must reject the analysis.

E. The Postal Service's Evidence Does Not Meet the Criteria To Justify Approval of a Newly Recommended Volume Variability Methodology

The Commission's Docket No. R97-1 opinion discussed several criteria that must be met to justify approval of a new methodology. The database must be adequate and appropriate. The model must be derived from economic theory and fit into the system to which it is applicable. The modeling approach must be appropriate. The estimation procedure must be suitable. Lastly, the results of the econometric equation or alternatives must be meaningful.

¹³² Id. at 826. Other similar standards applied by the Commission and noted favorably by the Supreme Court are "reliable principle of causality," "reasonable confidence," and "reasonable analysis of cost causation."

¹³³ Id. at 827, 833 note 29.

1. The Postal Service evidence does not develop and use an adequate database that is appropriately verified and complete

An appropriate model must be supported by an adequately developed and verified database.

(a) There are flaws in the database used by witness Bozzo

Witness Smith has concluded that the database used by Postal Service witness Bozzo was not adequately examined and verified for accuracy. Witness Smith stated that in view of the known deficiencies of the MODS database, as well as the changing nature of the data as verified by questions raised in interrogatories, that the database should have been subjected to substantial field verification for accuracy and completeness. Tr. 27/13173. He concluded:

Statistical data scrubbing is not an adequate substitute for on-site data verification. A proper approach to the verification of data is to select a sample of data items and perform a field check to determine reliability. Procedures must then be implemented to upgrade the data set if the data prove to be unreliable. Tr. 27/13174.

Witness Bozzo's analysis of mail processing costs is based on the Management Operating Data System (MODS), as was witness Bradley's analysis in Docket No. R97-1. According to the United States Postal Inspection Service, the low level of accuracy for MODS data results from inadequate conversion factors, improper data input by employees, and scales out of tolerance. Appendix F of the Commission's opinion in

Direct Testimony of witness Bradley, USPS-T-14 at 7, Docket No. R97-1. He also used data from the Productivity Information Reporting System (PIRS) in addressing sortation at Bulk Mail Centers. See Bozzo, USPS-T-15, Docket No. R2000-1.

PRC Op. R97-1, Appendix F, at 25.

Docket No. R97-1 notes that, "Even without the report of the Inspection Service, a conscientious examination of the data sets would disclose unmistakable internal evidence of serious errors." There is no evidence that the quality of the data has changed since Docket No. R97-1. Witness Degen confirms that the Postal Service has not presented any testimony on the collection of the MODS data describing field-based verification, correction, feedback and analysis for validity taking place as part of the data collection and entry process. Tr. 38/17386. The Table, "MODS Data from Selected Facilities", distributed by the Chairman, illustrated examples of the types of errors in the MODS database. In responses to the Chairman, witness Neels discussed the tables in detail. His general conclusions were that errors were fairly common.

Witness Neels concluded, in reference to piece-handling variables for any of the activities analyzed by witness Bozzo after employing the data scrubs: "I wouldn't be prepared to conclude that they were error-free" Tr. 46E/22335. In response to the question as to whether the errors remaining in piece handling variables are uncorrelated, witness Neels stated, "I wouldn't think so. I think there would be more likely to be some systematic relationships. There is some process that's giving rise to the errors, and we don't understand what that is. It's unlikely to fall equally on the just and the unjust." Tr. 46E/22336. In response to the further question of whether Witness Bozzo's scrubs removed enough erroneous data for any activity to allow him to

¹³⁶ PRC Op. R97-1, Appendix F, at 26.

Tr. 46E/22338-22348. The tables were marked PRC/UPS-POIR19-XE1.

estimate volume variabilities without an error in variables bias, witness Neels stated, "I think there are still some in his coefficient estimates." Tr. 46E/22336. Witness Neels' responses lead only to the conclusion that the database is inadequate for the analysis. There is a distinct possibility that biased answers will be produced due to data errors and the scrubbing process.

In contrast, witness Degen states that the MODS data are:

more than adequate for estimation of volume-variability factors. . . . The R² statistics obtained in the various models that have been considered are all very high.¹³⁸

However, witness Degen's conclusions do not substantiate the validity of the MODS data. By using data scrubs to eliminate outliers and data points which appear to be incorrect, witness Bozzo has assured that, even before starting the analysis, the R² will be higher than it would otherwise have been. The presence of a large number of variables in the estimating equations also helps to assure a high R². In responding to the Chairman's question of whether data scrubbing and the addition of variables could raise R², witness Degen indicted that both approaches would raise the R². Tr. 38/17391. Accordingly, witness Degen's comments about R² as substantiating the suitability of the MODS database are not credible. Tr. 38/17390-91.

Witness Bozzo has also claimed that "The MODS data are of acceptable quality." However, he acknowledges that time clock data may be less reliable than data collected in automated operations and that TPH in manual letter and flat sorting

Tr. 38/17315, lines 6-9. It should be noted that R² measures goodness of fit.

Direct Testimony of A. Thomas Bozzo, USPS-T-15 at 103, line 2.

operations are subject to error from weight and downflow conversions, and thus will not tend to be of equal quality to their automation counterparts.¹⁴⁰ One can see, however, that the results are potentially sensitive to data scrubbing. For example, in comparing the BY 1996 variabilities computed by witness Bradley with the BY 1998 variabilities computed by witness Bozzo, "There are large upward revisions to the manual parcel and priority variabilities, due largely to the application of tighter sample selection rules."¹⁴¹

The questionable nature of the database creates substantial concern about the estimated variabilities. As indicated by witness Greene,

If there is a single variable measured with error in a multiple regression model estimated by ordinary least squares the coefficient on that variable is pushed toward zero and the coefficients on other variables are pushed in unknown directions.

If more than one variable is measured with error, and essentially what I say here, all bets are off, the algebraic results are a horrible looking hash and nobody knows what directions the effects go. It's just never been worked out in detail. Tr. 46D/22103.

Given the questionable MODS database, the variability estimators may be biased, and nobody knows in what direction or by how much the estimator may be biased.

In conclusion, witness Bozzo has presented no evidence that the database is improved over its status in Docket No. R97-1, has not shown that there is a significant level of field checking of the data to assure its accuracy, and has performed a number

Bozzo, Direct Testimony, USPS-T-15 at 105 line 11 through 106 line 2.

AAP/USPS-T15-5. The specific sample selection rule referenced is the productivity check.

of scrubs that clearly remove some correct and incorrect data and leave other incorrect data present. All of these factors, plus the Postal Inspection Service's reservations about the data collection procedures and the testimony of witnesses Neels and Smith, demonstrate that there is room for substantial improvement in the database. Witness Smith summed up the evidence: "It is reasonable to conclude that the study is deficient in terms of its underlying database, and that the conclusions may be tentative, depending significantly on data scrubbing." 142

(b) The QICAP variable applied in an attempt to model capital investment has not been adequately justified and is inadequate

The value of the QICAP explanatory variable does not correctly measure the amount of capital used in a specific activity. Tr. 27/13181. The variable measures capital at the facility rather than the activity level. Accordingly, its use in witness Bozzo's regression equation leads to a misleading result. For example, in the analysis of flat sorting, QICAP measures not only the capital equipment associated with flat sorting at a specific facility, but also the capital equipment associated with all of the other capital equipment in the mail processing facility--such as the OCR, BCS, and other activities.

Witness Smith testified about an additional deficiency in the capital variable relating to the use of accelerated depreciation and maintenance practices:

¹⁴² Tr. 27/13174, lines 17-19.

QICAP is deficient from a computational standpoint. QICAP improperly accounts for depreciation and fails to consider equipment maintenance requirements. Tr. 27/13183.

From the viewpoint of activities in factories, there will usually be a relationship between hours of operation and levels of maintenance based on the age (i.e. depreciation) of the machinery after a few years. Older machines will maintain their operability as they depreciate through increased maintenance. Accordingly, in comparing vintages of capital it is necessary simultaneously to consider maintenance: maintenance hours, operating hours, and capital equipment are strongly interrelated. However, no management or maintenance time is included as a variable in the regression analysis.¹⁴³

Witness Bozzo asserts that from an economic viewpoint the machines have useful value consistent with the geometric perpetual inventory equation. Tr. 15/6349. He has justified the accelerated depreciation rate as being based on internal Postal Service studies. However, the studies are based on historical Postal Service experience, largely prior to the onset of the major automation efforts. The modern equipment that is currently being installed is automated, not mechanized, and is very different from the equipment installed previously, rendering the historical depreciation rates meaningless. Tr. 27/13184. Also, accelerated depreciation accentuates depreciation charges during the first few years of equipment life. As indicated by Dr. Griliches in "Economic Data Issues:"

Nevertheless, it is clear that the usual depreciation schemes which assume that the contribution of past investments declines rapidly and immediately with age are quite wrong. If anything, there may be an "appreciation" in the early years as investments are completed, shaken down, and adjusted to.¹⁴⁴

¹⁴³ Tr. 27/13184; see also OCA/USPS-T15-63, Tr. 15/6376.

¹⁴⁴ Zvi Griliches, "Economic Data Issues," *Handbook of Econometrics*, Volume III, edited by Z. Griliches and M.D. Intriligator, Elsevier Science Publishers, BV, 1986 (footnote omitted). Tr. 49/22545.

Dr. Griliches' statement is quite consistent with witness Bradley's prior decision in Docket No. R97-1 to eliminate from consideration data from plants that are ramping up and changing their volume significantly, as would be the case for newly installed or modified machines. It further supports witness Smith's conclusion that the QICAP variable has not been justified and is inadequate.

(c) Investment should be treated endogenously

Witness Bozzo treats capital investment as a predetermined variable. He states that the nature of the Postal Service's capital planning and deployment processes is such that capital and labor are not simultaneously determined, but rather that the available capital is taken as a "given" when labor work assignments are made. OCA/USPS-T15-56.

Witness Kingsley has provided examples of machine deployments.¹⁴⁵ The testimony suggests that the bulk of the machines were deployed in a one to three year time frame. Her testimony indicates:

This past year, all of the FSM 1000s were retrofitted with a BCR . . . first phase deployment of 175 machines is scheduled to begin in St. Paul, MN in March 2000. . . . second phase of approximately 400 additional AFSM 100s is also planned to start at the end of FY2001. [This implies that the first deployment would last in the neighborhood of 18 months] . . .The Postal service has increased the amount of SPBS equipment and keying stations over the last several years . . . Singulation and tunnel-scanning technology are being tested in the BMCs with the expectation of deployment in FY2001. USPS-T-10 at 11, 20 and 23.

Although equipment deployments may require more than several years for completion, it appears that a significant amount of equipment can be deployed within a year,

including all of the equipment at a specific mail processing plant, the unit of measure used in the study. One would expect that equipment would actually appear on the books of a mail processing facility when it is installed and is used and useful. Accordingly, it is quite reasonable to conclude that the capital deployment process is concurrent with the processing of mail in a given time period. Accordingly, capital should be treated as an endogenous, not predetermined, variable.¹⁴⁶

(d) The appropriate cost driver is still undetermined

In order to have an analysis of costs or labor demand, one needs a measure of output. Witness Neels concludes that witness Bozzo's measure of output is inadequate, maintaining that piece handlings are not an accurate measure of mail volume. The installation of major new pieces of equipment at a particular plant will have potentially substantial effects on mail processing operations at the site. Automated equipment is used to conduct multiple sorts on mail, obtaining appropriate levels of ZIP code sorting. Mail is subjected to either a larger or smaller number of sorts than would be the case for non-automated equipment, even though there may be overall cost reductions. Witness Neels testified that an increase in mail volume causes a disproportionate increase in piece handlings. Tr. 27/12805. Accordingly, witness Bozzo's study is deficient. Output is not proportional to piece handlings. There is no accurate measure of output.

Direct Testimony of Linda A. Kingsley, USPS-T-10.

The use of a simultaneous equations model is discussed below in Section III.E.2(e), infra.

Witness Neels developed a measure of output: first handling pieces ("FHP"). First handling pieces counts the unique number of mail pieces entering the facility and is, conceptually, an attractive measure of volume at the facility level. Since FHP is not a physical count of the number of pieces of mail, witness Neels estimated the relationship between FHP and TPH/F using a reverse regression on FHP and TPH/F in order to isolate the mismeasured variable FHP as the dependent variable. Tr. 27/12806.

As witness Neels indicates, an appropriate study of mail processing costs variability should focus on system level analyses, or at a minimum, on plant level analyses. If the analysis is conducted at the plant level, it should account explicitly for the effects of changes in the network that alter the number, configuration, or operating characteristics of plants. Tr. 27/12844. Witness Neels performed a system level analysis and adjusted the results to allow for the TPH/FHP relationship. The resulting volume variabilities were significantly above those of witness Bozzo.

Witness Stralberg disagrees with witness Neels' proposed use of FHP as a measure of output. Tr. 38/17271. Witness Stralberg's major objection is that variations in TPH/FHP are caused by network characteristics. Tr. 38/17278. Although he is correct, he misses a fundamental point: the network of internal processing coupled with the network of external handling constitutes the entire set of network characteristics.

He appears to ignore the internal configuration and interaction of activities, a major part of the network.

In his rebuttal testimony witness Bozzo criticized the approach and made what he believed were appropriate corrections. Tr. 46E/22150-57. Witness Bozzo's analysis, however, depends on a variety of assumptions or judgement calls. Although witness Neels' analysis could be further refined, there is no credible evidence that additional study would negate its relevance. However, witness Bozzo has not really focused on a major key issue: the key issue is not whether FHP as it stands in witness Neels' work is a correct measure, but, rather, whether the MODS database provides an accurate measure of output (which it does not) and whether a more appropriate measure of output could be developed, based, for example, on FHP.

(e) In conclusion, the database is not demonstrated to be appropriate

The MODS and other databases utilized for witness Bozzo's model have not been demonstrated to be appropriate for several reasons. First, the Inspection Service has questioned the reliability of the underlying data, and there has been no testimony to indicate that the data are subjected to any significant degree of field verification. Second, there are a number of documented errors in the database. Third, a high R² does not prove that the data are correct. The data scrubs and the inclusion of a large number of variables each bias the conclusions toward a higher R² than would otherwise have been the case. It is well known that the elimination of data can raise the R². Fourth, important variables draw upon the wrong data--e.g., output and capital. Accordingly, the modeling effort is based on an unreliable database. This deficiency has most certainly impacted witness Bozzo's variability conclusions.

2. The Postal Service's estimation model is not derived from the appropriate economic theory and fails to fit correctly within the system to which it is applied

The Postal Service's estimation model should be derived from appropriate economic theory. The following sections highlight the errors and omissions in the underlying assumptions of the Postal Service study. The estimation model therefore fails to correctly fit the Postal Service operating system.

(a) The economic assumptions and theory of the Postal Service's study are not clearly stated and appear to be wrong

Witness Bozzo's approach to the general modeling of mail processing facilities is wrong. For example, he assumes mail processing activities are performed independently of one another, but mail processing activities are not performed in isolation at the mail processing facilities. The operation of one mail processing activity is not independent of another. Tr. 27/13194. Witness Bozzo conducts his modeling at the activity level, rather than at the facility level, assuming that the activities are operated independently of each other. However, it is reasonable to expect interactions between activities simply because of the fact that they are housed in the same plant and rely upon a shared workforce. In a crowded facility, a high volume of mail in one activity could create congestion that affected the operation of otherwise unrelated activities. Tr. 27/12794. Furthermore, plant staffing levels are driven by the need to get mail downstream to the next sequential activity. As an example of the interaction of activities, witness Neels states:

Many facilities possess parallel processing operations for particular mail streams. Letters, flats, and parcels can all be sorted manually, or with the

aid of automated equipment. It seems highly unlikely that the operations of these parallel processing activities would not be affected by the way in which mail is allocated between them. Tr. 27/12793.

Witness Neels has also discussed some other major deficiencies. USPS/UPS-T1-13b. He notes that witness Bozzo's approach ignores the effects of plant openings, closings, expansions, and modifications.

Witness Bozzo has provided no evidence in support of the modeling of activities as being independent of each other. The assumption of independence of activities is inconsistent with the descriptions of mail processing operations provided by the Postal Service's operational witnesses. Tr. 27/12793. The relationship of processing patterns, volumes of mail, and the interaction of activities is inadequately addressed in witness Bozzo's analysis. Tr. 27/13195.

(b) The presentation of the labor demand function must be improved

Witness Bradley presented a cost equation relating TPH and labor hours in Docket No. R97-1.¹⁴⁸ He did not present it as a labor demand function. In contrast, witness Bozzo has presented a labor demand function.¹⁴⁹ He has indicated that he did not need to document the derivation of his labor demand function. Tr. 46E/22183. However, the economic theory underlying the definition of the purported relationship

Direct Testimony of witness Bradley, Docket No. R97-1, USPS-T-14. Witness Bradley stated on page 10 of the testimony that "Econometric models are a mixture of economic theory and statistics." He then referred to the estimated function as a cost equation. Subsequently, intervenors argued over whether the estimated function had meaning in the economic sense as a purported cost function, or whether the estimated function was simply a cost equation, possibly devoid of economic meaning.

Bozzo, Direct Testimony, USPS-T-15 at 44 through 50.

between hours and piece handlings as portrayed in witness Bozzo's testimony is somewhat confusing.

A labor factor demand function has input factor prices and the price of the product as independent variables. ¹⁵⁰ In contrast, witness Bozzo's labor factor demand function includes output, factor prices, and a variety of other variables. Witness Bozzo treats investment as predetermined, which has been discussed previously as being inaccurate.

In comparison, a cost function has output as a driver; this variable is included in witness Bozzo's labor demand function along with a variety of other variables, some of which are control variables and some of which relate to wages or other factors of production.

The importance of the specification of the function being estimated was highlighted in Docket No. R97-1.

A necessary first step in accurately characterizing the relationship between volume and costs at the facility level is a precise statement of the true causal relationship between these two variables that the econometric analysis is attempting to measure.

Without this precise statement of the relationship to be estimated the following questions cannot be answered. What variables should be included in the econometric model? What estimation technique should be applied? In addition, any measure of the quality of an econometric estimation procedure requires comparing the value of the estimate obtained to its true value over possible realizations of this estimate. Therefore, a precise definition of this relationship is not simply an exercise in intellectual rigor for its own sake, but a vital input to any process used

Econometric Models, Techniques, and Applications by Michael D. Intriligator, Ronald G. Bodkin, and Cheng Hsiao is the source documenting the basis for these comments. The theoretical statements on production, cost, and factor demand function in Chapter 8 of the textbook are well known.

to judge the validity of an econometric procedure used to recover an estimate of the relationship. PRC Op. R97-1, Appendix F, at 6 to 7.

Accordingly, witness Bozzo's labor factor demand function is somewhat *ad-hoc* in its selection of variables. As the Commission indicated in Docket No. R97-1,

Econometrically regressing processing times on total piece handlings and a collection of controls without consideration of the underlying economic theory may yield a very inaccurate characterization of the true relationship of cost to volumes. PRC Op. R97-1, ¶3013.

An additional theoretical misunderstanding over the estimation of the relationship between TPH/F and hours was highlighted by witness Degen in discussing the expansion path, advocated by OCA witness Smith, as the relevant concept for the measurement of volume variability.¹⁵¹ Witness Degen stated:

I thought Mr. Smith was saying they would go from A to C along a pooled kind of line, but then during his direct, he seemed to recant that and say, no, rural plants won't become city plants and vice versa, which was the point I was trying to make all along. Tr. 38/17872.

The type of muddled testimony that leads to this confusion was highlighted by witness Bozzo in his testimony:

The Postal Service's mail processing labor demand analysis is consistent with Dr. Smith's "expansion path" approach, which he claims is the conceptually correct economic relationship to estimate. Tr. 27/13167.

Witness Bozzo states:

Witness Smith himself establishes that the expansion path argument does not constitute a criticism of the Postal Service's variability methods at all, for the simple reason that the cost function and expansion path are conceptually identical. Citing several authoritative texts, Dr. Smith explains, "the set of all possible pairs of output and cost along the expansion path define the cost curve." Tr. 27/13267. He further notes that "[I]n general, one can obtain a system of factor demand functions"

Witness Smith's diagram, Table 5 at Tr. 27/13211, portrays the relevant expansion path.

derived from the expansion path or cost function. Id. He also confirmed that the short-run cost function simply represents an alternative expansion path, and that the long-run cost function must be below the short-run cost function for every level of output. Tr. 46E/22199-200.

It follows immediately from the theory that Dr. Smith cites that the degree of volume-variability along the expansion path is the elasticity of labor demand (workhours) with respect to output. These are precisely the quantities Dr. Bradley and I estimated. Tr. 46E/22200.

Several comments are needed to explain that the Postal Service witnesses do not accurately portray witness Smith's position. First, witness Bozzo has measured a labor demand function. He also states that witness Bradley measured a labor demand function, although witness Bradley was under the impression that he measured a short run cost equation.

Second, although nothing witness Bozzo has stated in the above testimony is theoretically wrong, *per se*, nevertheless, the sentences are misleading. Although witness Smith did, in fact, confirm that the short-run cost function "simply represents an alternative expansion path," it should be noted that the appropriate function is the *long-run* cost function. Witness Bozzo is confused about the short run and long run. Finally, witness Bozzo also mingles terms related to cost functions, expansion paths, and factor demand functions.

Witness Degen's alleged confusion is a result of the imprecise specification of the underlying economic theory by witness Bozzo. It is clear that the appropriate relationship that should be estimated is the expansion path. According to Intriligator, "The set of all possible pairs of output and cost along the expansion path defines the

cost curve."¹⁵² Witness Bozzo has maintained that he has estimated a labor factor demand function. Such a function is not a cost curve or an expansion path. However, he also maintains that the various hour/TPH relationships do not necessarily represent cost minimization, an assumption generally used in such analyses. He furthermore ignores the addition of plants to the network of mail processing.

Witness Smith has presented an alternative interpretation of theory presented by witnesses Degen and Bozzo. Tr. 27/13211. Assuming that plants are operating efficiently, that there are plant additions, and that all factors are variable, then the relevant expansion path for labor use would be the "pooled" line. However, these assumptions (particularly as related to plant efficiency and plant additions) were not explicitly stated to him during cross-examination. The inherent deficiencies of Witness Bozzo's analysis precluded a more definitive answer.

(c) The Postal Service's study is short run but it must be longerrun so as to recognize major investment plans to correctly estimate movement along the facility expansion path

The Postal Service's study is short run, but a long-run study is needed to estimate costs along the facility expansion path. The "long run" is defined as the period of time over which all inputs are variable. If some inputs are variable, but others are not, then the resulting costs are short run. As the Commission has indicated, there are many flavors of short run depending upon what inputs can be varied over the length of time considered. PRC Op. R97-1, ¶3035. The Commission has indicated that the

¹⁵² Intriligator, op. cit., at 278.

appropriate horizon for the Commission's work should reflect the period of time that the Commission's recommended rates would remain in effect if accepted by the Postal Service Board of Governors. PRC Op. R97-1, ¶3019.

Witness Neels has testified that the long run can be interpreted in terms of functional terms: the difference between a short-run response to an increase in volume and a long-run response has to do with which aspects of postal operations are held constant, and which are allowed to vary. The constancy of factors of production is equivalent to the definition of the short run. The change in factors of production can include variations in staffing, automation and mechanization, changes in mix of machines in a plant, mix of activities, systematic relationship between the mix of activities present and the volume of mail processed. Tr. 27/12776. The long run is the time period over which all aspects of operations can be adjusted and can be measured by modeling the economic relationships.

It appears that the factors of production can be varied during the rate effective time period. Since very significant changes to the mode of operations can be made over the rate effective period, the rate effective period is probably the lower bound of the long run. Variables that should be considered for modeling in order to have a long run analysis include investment, capacity utilization, changes in the postal network

Clearly a public building, such as a central city post office, constructed during the WPA era, will not be variable during such a short time; however, incremental additions, modifications, and deletions of space could be made in the building or in adjoining buildings through the rental process. Similar comments could apply to other types of assets.

including the addition of activities at mail processing plants and the addition of mail processing plants, the manual ratio, and possibly other factors.¹⁵⁴

By failing to model these variables, witness Bozzo has a short run labor demand function. He acknowledges that his analysis is short run, and it is surprising that his variabilities are as high as they are, given the short run nature of the model.

(d) Newly presented network information is not adequately incorporated into the Postal Service analysis

Both witnesses Degen and Bozzo have introduced important network concepts. The Commission did not have an opportunity to examine in detail network issues in reviewing witness Bradley's testimony in Docket No. R97-1. However, the Commission has already summarized the importance of the network issue:

If the number of facilities varies with volume, then witness Bradley's elasticities are flawed because they do not correctly represent the variability of mail processing labor costs for the *entire postal system*. Mr. Degen states the number of facilities is fixed. Variations in mail processing costs in response to sustained changes in volume are not considered at the *system* level. PRC Op. R97-1, Appendix F at 21.

In this case, the network concept, which is new to the segment 3 analysis, does not appear to have been developed adequately. Only one variable, delivery points, enters the analysis in witness Bozzo's testimony.

Witness Smith testified that mail processing activities and sites do not stand alone in terms of the network of originating and destination nodes. Tr. 26/13193. There are a number of network issues and witness Bozzo's model only deals with one

The word "considered" is used because a fully stated economic theory accompanied by an econometric analysis would be necessary to arrive at more definitive conclusions.

of the issues. First, there is the in-plant network of activities that feed mail to each other. However, witness Bozzo treats activities as being independent of each other. In contrast, witness Neels has advocated the analysis of mail processing at the plant level. A second type of network influence is the position of the mail processing plant in the mail flow between other mail processing plants. Witness Bozzo shows that the size of facilities and their mail processing operations depends not only on the volume of mail processed, but also their position in the Postal Service's network. USPS-T-15. A third type of network effect is apparently the delivery configuration of the service territory. Witness Bozzo measures this network configuration with a variable measuring the number of possible deliveries.

Of all of the possible types of networking effects, witness Bozzo addressed in his model only the possible deliveries. He did not adequately address the networking of activities at the plant level or the interchange of mail between plants. Clearly both of these types of network effects might have an impact on labor demand. USPS-T-15 at 47. One could expect the selection of activities at a plant, the addition of activities, and the interrelationships of activities to impact mail processing. The various network factors are related to the length of processing windows, the complexity of mail processing schemes, the relative amount of labor required for set up and take down activities, the mail processing operation's role as a gateway or backstop, and other indictors of the level of costs. Tr. 27/13194.

(e) Serious consideration must be given to simultaneous modeling of activities in light of witness Degen's comments on the network interaction of postal facilities

Capital investment, the manual ratio, capacity utilization, and possibly other variables are endogenous to the modeling effort, and consideration must be given to modeling them simultaneously. The use of capital equipment clearly has an impact on the demand for labor. However, investment in plants and equipment is also affected by the need for additional capacity, and therefore capital, to handle output. Accordingly, capital should be treated as an endogenous rather than predetermined variable. The importance of capital has been highlighted:

It is absolutely clear that mechanization and automation are integral elements of the response of the Postal Service to growth in mail volume. As automation programs progress, the focus of these programs necessarily must switch from the substitution of capital for labor to providing enough capital and enough processing capacity to accommodate growth in volume. These fundamental facts imply that no analysis of mail processing cost variability can be complete without a full and adequate treatment of capital costs. Tr. 27/12845.

Similarly, the manual ratio is affected by decisions related to capital equipment, and these decisions are also affected by volume. Again, this is a variable that is endogenous but has been treated by witness Bozzo as exogenous in their modeling efforts. Therefore, the labor demand equation needs to be estimated as part of a simultaneous equations model. The application of such a model has been succinctly stated by witness Neels:

Many aspects of postal operations are likely to affect the structural relationship between mail processing labor costs and mail volume. However, many such aspects of postal operations--including capital intensity, choice of sorting technology, and the structure and organization of the mail processing network--are under the control of the Postal Service, and likely themselves to change systematically in response to changes in mail volume. Including such explanatory variables in the regression model without accounting properly for their endogeneity is likely to lead to simultaneity bias. Moreover, even if the econometric problems associated with the inclusion of a right hand side endogenous

variable could be adequately resolved, the resulting structural model would produce incomplete results. While it would capture the direct effects of volume on labor costs, holding other decision variables constant, it would exclude the indirect effects exerted by volume growth through its influence on these other decision variables.

In such a situation, the appropriate econometric model is a reduced form model that excludes from the right hand side all endogenous variables. The estimated coefficient on volume in such a model captures both the direct and indirect effects of volume on labor cost. The result is a more comprehensive measure of the volume variability of labor costs, and one that comes closer to meeting the requirements of the Commission. Tr. 27/12938-39.

Accordingly, a model that considers the interaction of activities and variables is necessary. Further testimony supports this conclusion:

Capital, capacity utilization, and the manual ratio need to be treated as endogenous in a simultaneous equations system in order to allow for the long-run nature of the process. The analysis needs to be conducted at the plant or system level, not the unit activity level. Tr. 27/22369.

Witness Neels comments on the importance of the network:

If analysis is conducted at the plant level, it should account explicitly for the effects of changes in the network that alter the number, configuration or operating characteristics of plants. Tr. 27/12844.

It is clear that the number of mail processing plants changes from year to year through the construction of new plants, the refurbishment and upgrading of existing plants, and the addition of mail processing activities at plants. In addition, activities within plants interact, and, finally, in the modeling of activities there are simultaneous equations issues associated with the interactions.

(f) The Postal Service's treatment of homotheticity appears to lead to incorrect conclusions

Witness Bozzo's treatment of homotheticity is wrong. Witness Bozzo maintains that "capital and labor variabilities will be identical, in equilibrium, under the assumption

that the cost pool-level production (or cost) functions are homothetic." USPS-T-15 at 40. This would mean that the capital intensity of mail processing is unaffected by growth in mail volume. Nevertheless, we see a major push by the Postal Service towards increased capital investment and automation by the Postal Service. Clearly, witness Bozzo's modeling of postal operations does not comport with what we are observing in terms of speeches, equipment installation, and investment efforts by the Postal Service. ¹⁵⁵

Witness Greene offers a red herring from the Postal Service's kettle of fish on homotheticity, noting that "Nowhere does the theory state that the firm in equilibrium will never adjust its capital labor ratio in response to changes in relative prices." Tr. 46E/22048. Witnesses Bozzo, Degen, Bradley, and Greene have not argued that changes in relative prices are driving Postal Service investment, nor have they provided testimony on the purported changes, if any. Accordingly, witness Greene's testimony on this subject is irrelevant.

(g) Cost minimization issues have been raised that are unresolved but may be significant in resolving segment 3 <u>issues</u>

Witness Bozzo referenced Yasushi Toda on the estimation of a cost function when the cost is not minimum.¹⁵⁶ Resource and output decisions could be different for

The Postmaster General and other senior members of management have delivered various speeches on the importance of investment efforts. Types of equipment installation are delineated by witness Kingsley, *supra* Section III.E.1(b).

Yasushi Toda, "Estimation Of A Cost Function When The Cost Is Not Minimum: The Case Of Soviet Manufacturing Industries, 1958-1971," *The Review of Economics and Statistics*, Vol. LVIII, August 1976, 259-268.

two different firms, one cost minimizing and one non-cost minimizing. The Toda analysis is relevant to the proceeding insofar as witness Bozzo indicates that cost minimization is not a necessary assumption for his estimation of labor demand.

However, the issue of cost minimization becomes an issue in considering the long-run expansion path. Figure 5, "Analysis of Response to Volume Growth," in witness Degen's testimony can be subject to a variety of interpretations. USPS-T-16, at 29. For example, one could assume that it is the labor demand function related to the expansion path for the set of existing plants, remembering that the analysis does not consider (incorrectly) the addition of new plants. The labor demand function results from the expansion path but is not the expansion path. One would have a group of short-run relationships grouped around a long-run relationship. Alternatively, one could assume that Plant A and Plant B are identical plants, with Plant B operated by incompetent management, as an example of the interpretation of Toda's article. Further clarification of assumptions by witness Bozzo is needed: although witness Degen has provided a graph of the hours/TPH relationship, there appear to be alternative explanations to the relationship being estimated.

(h) The analysis fails to include any measure of capacity utilization

Witness Bozzo's analysis has not adequately considered capacity utilization and a variety of potentially useful variables for incorporation in his analysis. These variables include capacity utilization, space utilization, age of facility, degree of support costs,

degree of flex labor, and location.¹⁵⁷ One would expect to find capacity utilization to be a short-run effect that could explain much of the variation of labor usage around the trend line. Its absence lets the short-run trends predominate.¹⁵⁸

(i) The Postal Service has not applied appropriate economic theory in deriving a model to fit correctly within the system to which it is applied

As discussed above, the Postal Service needs to apply more comprehensively and with greater detail the economic theory underlying the modeling effort. At the present we have an *ad hoc* modeling effort involving the misspecification of relationships between variables. Regardless of the R² measurements obtained, a model is not meaningful if the underlying theory is not appropriately specified.

 The Postal Service's limited discussion of the modeling approach does not satisfactorily indicate that it is consistent with the underlying data

The modeling approach must be consistent with the underlying data. The capital variable QICAP does not use the relevant data to measure capital. Also, the application of intuition and common sense to the data indicates the modeling approach is inconsistent with the data. Finally, the econometric model is inconsistent with the postal processes.

With the exception of capacity utilization, these variables are discussed in Appendix F to the Opinion in Docket No. R97-1 at 10. It is clear that none of these variables, with the exception of location, can be accounted for by the fixed effects approach.

The Commission noted that the cyclical nature of mail volume could lead to low variability estimates. PRC Op. R97-1, Appendix F, at 13.

(a) The Postal Service's variable QICAP does not correctly model capital

The deficiencies of QICAP have been previously noted. The major deficiencies are that the variable is modeled at the facility rather than the activity level and is not a comprehensive measure of capital (QICAP apparently does not measure all of the capital associated with an activity). The econometric problem that QICAP creates is well known: the independent variable is not a driver of the dependent variable.

The deficiency of QICAP is best illustrated through a simple example. A specific activity at a mail processing plant may be highly automated. Such an activity would presumably have a large amount of capital equipment associated with it, causing QICAP to have a higher value than would otherwise be the case. In contrast, another activity at the same mail processing plant could be in a state of obsolete mechanization, with a low value of capital equipment associated with it. Overall, however, QICAP might have a relatively high value due to the automated equipment at the mail processing plant, and this high capital equipment value would be applied in the analysis of activities with relatively low amounts of capital associated with them. This is incorrect.

(b) Certain Postal Service testimony indicates that intuition and common sense suggest that volume variability approaches 100 percent

Witness Smith's testimony indicated that TPH/TPF and hours varied together; he plotted a number of graphs and called the results visually compelling. Tr. 27/13215. There appears to be a very strong correlation between TPH/F and hours. Witness Smith stated:

Dr. Bradley's analysis included a large number of variables in addition to hours and TPH. There is, however, a difference between the number of variables and the amount of information presented. All of the variables were either derived from the scrubbed data of hours and TPH via cross products, or were simply time trend or dummy variables. Except for time trend and seasonal information, the actual data show that TPH and hours vary together closely. Tr. 27/13217.

Witness Bozzo has added a few variables, but they are not correctly modeled (as discussed previously), and so it is difficult to ascertain what the final effect on the measurement of variability will be once the models have been improved. As a check of sanity on the modeling effort, however, it should be noted that the existing information is indeed visually compelling.

Witness Smith did not confirm that he believed more than two variables would be needed for the modeling process, although common sense would make such a requirement highly likely. One would normally expect that multiple variables would be needed; however, witness Bozzo's analysis has not yet presented a correct regression, so it is not known whether the result will be any better with additional variables. One would expect that explanatory power would increase once the equations are correctly modeled and additional variables are used. Whether this will reduce variabilities remains to be seen.

Nevertheless, the simple visual portrayal of the visual connection between TPH/F and hours has been useful. Common sense indicates that a relatively high

Common sense would dictate that trend lines and quantities raised to a power are not additional variables in the context of this discussion. An additional variable, for example, would be QICAP.

volume variability could be expected; in fact, witness Neels found variabilities in excess of 100 percent.

(c) The Postal Service's econometric model is inconsistent with the economic modeling of the postal process

Witness Bozzo has used the fixed effects approach in the modeling of mail processing costs. There is nothing wrong with the use of a fixed effects approach, *per se.* However, the application of the fixed effects in this proceeding is deficient. The fixed effects will describe the impacts of whatever relevant variables are omitted. As witness Degen indicated, one really doesn't know what variables the fixed effects are modeling. Tr. 38/17380-81. Accordingly, the econometric problem lies in the context within which the approach has been used. As noted succinctly by the Commission in Docket No. R97-1:

Econometrically regressing processing times on total piece handlings and a collection of controls without consideration of the underlying economic theory may yield a very inaccurate characterization of the true relationship of cost to volumes. PRC Op. R97-1, ¶3013.

In addition, there are problems with the selection of variables, the selection of control variables, and modeling of the variables. As previously noted, the major difficulty is that a short-run relationship is estimated. The Commission provided some very important comments in Docket No. R97-1 as related to the generation of short-run estimates. Although witness Bozzo has moved to quarterly data, the comments are still relevant, recognizing that the Postal Service witnesses advocate the rate cycle as the relevant time frame (as does witness Smith, who simply suggests that it be measured on a long-run basis):

The cyclical nature of mail volume over a rate cycle implies that the relationship between input use and mail volume across adjacent accounting periods will primarily reflect seasonal variation in mail volume. On the other hand, staffing levels, and therefore hours, would be set to reflect sustained annual or postal rate cycle volume levels. Therefore, large changes in volume across accounting periods can occur with little change in labor hours across accounting periods, leading to a low variability estimate. PRC Op. R97-1, Appendix F, at 11.

Accordingly, there are a number of modeling issues remaining, such as a focus on activities rather than the system or unit level, choice of variables, specification of the economic model, and choice of the long run. The needed modifications would require the recasting of the modeling effort.¹⁶⁰

4. The Postal Service's estimation procedure is not suitable to the needs of the problem and should not be used

The Postal Service's estimation procedure is unsatisfactory as it is not suited to the problem and should not be applied in this case.

(a) The Postal Service has not presented a correct estimation procedure for application in this case

The Commission has indicated that the fixed effects methodology needs to control only for those specific aspects that do not change over time for a given facility:

The fixed effects can only control for effects that do not change over time for a given facility, whereas in the inclusion of regressors that vary overtime and facility control for specific effects that can vary over time for a given facility and across facilities and can be included in a model that also contains a fixed effect. PRC Op. R97-1, Appendix F, at 11.

The Commission has also concluded:

These comments assume, of course, the existence of an adequate database.

"Fixed effects" is just a technical way of saying that each facility is allowed to have its own intercept or constant term in the translog equations that witness Bradley fits for mail processing labor time. The differences in these intercepts will capture any differences between average processing labor times at different facilities that are not captured by differences in the sample means of the other variables of the translog equations, including the sample means of the terms containing total piece handlings at the facilities. But this does not mean that the differences in the intercepts are completely unrelated to piece handlings. Nor is it possible for the fixed effects to control for differences between the facilities that are not fixed over time. Consequently, the fixed effects are far from an ideal set of controls. PRC Op. R97-1, Appendix F, at 41.

Accordingly, the fixed effects approach as cast by witness Bozzo, is far from ideal as an econometric methodology. Witness Neels indicated several major needed corrections. Tr. 27/12843-48. Only a plant or system level analysis can fully capture the interactions between activities. If an analysis is conducted at the plant level, it should account explicitly for the effects of changes in the network. Second, capital costs are important in the analysis of the Postal Service's response to changes in volume. Third, the growth of delivery points must be considered a part of the growth in volume. Finally, the analysis of mail processing costs requires an appropriate cost driver.

Witness Smith added the following theoretical issues: that the underlying economic assumptions be presented in a more comprehensible manner, with particular emphasis focused on assumptions about homotheticity, economic efficiency, networks, and the nature of the function being estimated. Tr. 27/13224-25. He also indicated that additional explanatory variables could be needed, and that there needed to be data improvements. He notes that:

The modeling effort needs to be modified. Correct variables for output (measured in terms of pieces of mail processed, not pieces handled or

fed), capacity utilization, and capital (measured in terms of the processing operation with which it is associated) and other variables are needed. Capital, capacity utilization, and the manual ratio need to be treated as endogenous in a simultaneous equations system in order to allow for the long-run nature of the process. The analysis needs to be conducted at the plant or system level, not the unit activity level. If the analysis were conducted at the unit level, then there would need to be a modeling of the interrelationships of activities. The appropriate variables should be used in estimating labor demand, not conditional labor demand. The analysis should give careful consideration to the fixed effects approach correctly modeled for facilities and time. Tr. 46E/22369.

Finally, witness Smith has noted that the appropriate method of estimation would be along the long-run facility expansion path as related to major investment plans. Tr. 27/13189. He advocated using witness Bozzo's "between model" as the least bad first approximation of this approach.

(b) When witness Neels corrected for errors in witness Bozzo's direct testimony, variabilities over 100 percent were actually found

Witness Neels provided an alternative calculation of volume variability. His analysis at the MODS-level and the shapes-level showed that TPH/F grows disproportionately faster than FHP. Tr. 27/12832.

Witness Neels also performed a time series analysis using system-wide mail processing costs. Adjusting the volume variabilities computed by witness Bozzo for the TPH/F vs. FHP relationship, he found that most of the corrected volume variabilities were well in excess of one, indicating the presence of diseconomies of scale. His estimates of volume variability ranged from a low of 98 percent to a high of 123 percent. He stated that in a number of instances the difference from 100 percent was statistically significant. Tr. 27/12839.

(c) The cross sectional "between" model was considered to be the "least bad" of the alternatives presented in the Postal Service's direct case but is unsatisfactory

From a theoretical viewpoint, the cross sectional "between" model is not superior to the fixed effects or pooled models. This was highlighted by witness Smith during cross-examination when he agreed with the statement that "There are no theoretical grounds for concluding a rejected model provides a better estimate than Models A and B". Tr. 46E/22371. Although it is true that cross sectional models are frequently used, nevertheless, when one has a larger dataset it is possible to use other estimating techniques, assuming that the models are correct. The elements of the "between" model that appeared to make it "least bad" for use in this case were highlighted in the Commission's opinion in Docket No. R97-1:

Differences in the operation of facilities of different sizes would more accurately reflect the relationship between volume and costs that would occur over a production period as long as a rate cycle than would differences in the operation of the same facility over adjacent time periods. Consequently, an estimating procedure which primarily relies on the cross sectional dimension of the panel dataset is preferred to one that relies on differences over time within the same facility, such as the fixed effects estimator. PRC Op. R97-1, Appendix F, at 14.

When asked to comment on the last sentence of the above quote, witness Degen offered the following comment: "I think it is wrong." Tr. 38/17384. He continued:

I think it is wrong fundamentally because it assumes that existing plants will morph into their larger counterparts as volume grows, and that is just not true. And so any model that tries to infer what is going to happen when volume increases, by comparing one plant to the other plant, is going to be wrong. You really need to look at what is going to happen in each individual plant because there are cost causing characteristics associated with each of them that will be unique to them. Tr. 38/17384.

Witness Degen presents a new theory of economic morphing (no other witness has presented or discussed a theory of morphing). He is focused on differences in intra-plant specific costs rather than inter-plant costs which would show the long-run cost variabilities. Witness Degen is wrong. No plants are morphing; the "least bad" approach simply looks at long-run changes on a cross sectional basis.

5. Any meaningful discussions of the results of the Postal Service's econometric equations or the alternatives, in terms of the values, signs, or other relevant information for the variables, including the models proposed in NOI No. 4, are moot

Notice of Inquiry No. 4, "Concerning Mail Processing Variability Models," issued August 2, 2000, sought input on the comparison of four models: the facilities-based fixed effects model presented by witness Bozzo in his direct testimony, USPS-T-15, and denoted by the Commission in the Notice as "Model A"; a time-based fixed effects model with time as the dummy variable to estimate the fixed effects, denoted as "Model B" in the Notice of Inquiry; a random effects model, one of which was generated by the Panel command by witness Bozzo and presented in his testimony; and a pooled model, one of which was generated by the Panel command by witness Bozzo and presented in his testimony. The objective of the NOI No. 4 appeared to be the resolution of which model (if any) was superior for estimating the volume variability of labor. 161

In responding to the NOI, witness Smith concluded:

Responses to NOI No. 4 were filed by OCA witness Smith (OCA-RT-4), Tr. 46E/22362-369; by Postal Service witnesses Bozzo, Tr. 46E/22244-55, Greene, Tr. 46E/22122-30, and Bradley, Tr. 43/18376-377; by UPS witness Neels (UPS-NOI/POIR-T-1), Tr.46E/22269-85; and by MPA witness Elliott (MPA-ST-2), Tr. 43/18653-60.

I believe that the econometric relationships propounded by Witness Bozzo are basically incorrect from a theoretical viewpoint, regardless of whatever statistical properties are propounded as being achieved. If a hypothesized economic relationship is incorrect, the fact that the relationship can be estimated with a high degree of accuracy and precision is irrelevant.¹⁶²

He reiterated the major deficiencies, including the modeling of the variables, level of analysis, and selection of variables that would need to be corrected prior to the estimation of a correct model. Witness Smith also concluded that a correctly specified fixed effects approach should be given careful consideration. For these reasons, meaningful discussion of the results of the Postal Service's studies is moot.

F. MPA's Suggestion To Extend witness Bozzo's Work to Other Cost Pools Is Not Sufficiently Demonstrated

MPA's witness Cohen has proposed that the Commission extend, "As an interim measure pending a complete econometric analysis of the allied operations," some of witness Bozzo's volume variability results to 14 cost pools involving allied operations. Tr. 24/11287, 11329. Witness Cohen uses the composite variability of witness Bozzo from the sorting operations as an upper bound as the "most accurate available estimate of the volume-variability factor in allied operations." *Id.* The effect is to lower the volume variability recommended by the Postal Service, more specifically the variabilities used by Postal Service witness Van-Ty-Smith. *Id.* at 11329-30.

The OCA is opposed to witness Cohen's recommendations because they would effectively apply the quantitative results from the unsubstantiated and controversial

Tr. 46E/22364. See also Smith, Rebuttal Testimony, at 8, line 1.

theoretical model of mail processing variability presented by witness Bozzo. Consequently, witness Cohen's suggestions should be rejected for several reasons. First, it is clear that witness Cohen is relying for quantitative support upon the variabilities calculated by witness Bozzo's analysis. Tr. 28/11330. It is demonstrated previously in this brief that witness Bozzo's model is deficient in many respects and that witness Bozzo's volume variabilities are suspect and cannot be relied upon as a basis for moving away from the established 100 percent volume variability method. Likewise, it would be improper to rely upon witness Bozzo's unsupported variabilities as a proxy for the allied operations cost pools.

Witness Cohen also relies on subjective operational experience as support for her recommendation, but recognizes that if the Commission stays with the 100 percent method the Commission could have problems applying the analogies that she suggests to fashion separate variabilities for the allied operations. Tr. 24/11339. In fact, there is an insufficient record to select independent variabilities for particular allied cost pool operations. Witness Cohen could only suggest that, in her opinion, the variabilities for the allied operations would be lower than the variabilities for sorting operations. *Id*. However, this guidance only indicates that the variability might be something less than 100 percent. She has offered no further support on which to ground a decision as to the precise variability for the allied operations in the event the Commission rejects witness Bozzo's analysis and applies a 100 percent variability.

Second, the suggestion that witness Cohen's approach is only an "interim measure" is not a satisfactory justification. Tr. 24/11287. The Commission currently has an established methodology of 100 percent volume variability. The burden of

demonstrating sufficient grounds for modifying that policy is on the proponent of the modification. The Commission has been clear about this.¹⁶³ The burden on MPA is thus not to merely justify its suggestion as if witness Bozzo's testimony were acceptable to the Commission. MPA must first either demonstrate that witness Bozzo's method is correct or independently demonstrate the reliability of the variabilities for the sorting operations that it seeks to average. MPA has done neither. Second, MPA must also demonstrate that witness Bozzo's conclusions apply to allied labor.

MPA witness Cohen testified only briefly in support of witness Bozzo's analysis. Tr. 24/11282-84. Witness Cohen states that witness Bozzo "has squarely addressed" defects in the previous analysis that was rejected by the Commission in Docket No. R97-1. She points to three adjustments—inclusion of lag terms that reflect cost responses over a full year, more modest scrubbing, and the addition of wage, capital and network variables, and that witness Bozzo's quantification is grounded in "operational realities." For the many reasons stated previously on this issue, these changes are not sufficient to validate witness Bozzo's analysis. Essentially, witness Bozzo's changes do not begin to resurrect the discredited analysis in Docket No. R97-1. It is not enough to merely assert that operational characteristics suggest a volume variability of less than 100 percent. The subjective interpretations of witnesses Degen and Cohen do not replace the need for satisfactory quantitative demonstration of that view. The only support offered by witness Cohen is that "the time required to set up

For discussions regarding the burden of proof, see, *supra*, pages 12-14 and III.C.

and tear down a scheme . . . [can] be a considerable portion of the total time on that scheme," and that it is "generally independent of the volume run through it." *Id.* at 11284. Even this testimony contains two qualifications: "can be" and "generally." This qualified testimony is based upon the witnesses own field observations. It is clearly not definitive enough to warrant its application without significant and demonstrable quantitative support.

Third, even if the Commission were to accept witness Bozzo's analysis as reasonable, witness Cohen testified that the Commission must still determine whether it is appropriate to extend by analogy witness Bozzo's econometric results to the allied cost pools. Tr. 28/11340. She recognizes there is no basis for a quantitative measure of the actual operations in the non-MODS offices that she examined. Tr. 24/11334. Even witness Bozzo did not have sufficient confidence in his variabilities to testify as to their application by proxy to other cost pools. His own testimony indicated the Postal Service has no quantitative support for the assumptions of witness Bradley in Docket No. R97-1 that led to extrapolating his analysis to non-MODS activities. USPS-T-15 at 134. In part, this is because of the lack of piece handling data. *Id.* at 135. Witness Bozzo only provided qualified support for the use of econometric results for analogous operations. He said the use of econometric results is "potentially" superior to the

The "operational realities" suggests a short-run approach, which is not justified by the analysis. It should be based on the long-run expansion path.

USPS-T-15 at 133-39. In fact, witness Bozzo did not have sufficient confidence in his analysis to suggest any variabilities for allied labor operations.

He only generalizes and does not say which econometric results would be applicable. Tr. 28/11285.

IOCS-based method. Like witness Cohen, witness Bozzo's testimony is qualified and can hardly be viewed as a ringing endorsement of using these analogies to derive more accurate estimates of volume variability.

Also, witness Cohen applied, by analogy, witness Bozzo's analysis to four operations at non-MODS facilities, three manual operations and one DPS. Tr. 24/11333 and 11336. It should also be remembered that in Docket No. R97-1 witness Bradley proposed to extrapolate the variability results to non-MODS offices. Tr. 27/13165. The Commission rejected the proposal. PRC Op. R97-1, at 91.

Witness Cohen testified that it is intuitively obvious that non-MODS manual letters cost pools are similar in character to Function 1 MODS manual letters cost pools. Tr. 24/11285. However, it is not so intuitively obvious when one considers the well-known differences between MODS and non-MODS facilities. On cross-examination, witness Cohen agreed that although there is a lot of comparability between MODS and non-MODS operations, there are also differences between MODS and non-MODS operations. For instance, size varies; this affects the "network configuration" and impacts the equipment and facilities that handle different volumes of mail and the number of separations. Thus, the application of the variabilities to analogous cost pools is not so "obvious" when there is no quantitative support for the conclusions, even when the analogy is applied primarily to manual operations. Tr. 24/11308.

Finally, witness Cohen justifies a less than 100 percent variability on the grounds that there are significant planned idle periods on the platform so that labor is available

Tr. 24/11335. See also Tr. 27/13153, note 4.

to unload trucks. Tr. 24/11286-87. To the extent that the facility is overstaffed to handle peak loads, the idle time is irrelevant to the analysis. In any event, witness Cohen is applying a short-run analysis that the Commission has already rejected in Docket No. R97-1.

G. A Working Group Should Be Recommended by the Commission To Discuss and Reach Agreement on the Technical Issues Surrounding the Mail Processing Volume Variability Problem

The volume variability analysis has consumed major resources, apparently up to five years for the initial work presented by witness Bradley, and another five person years of work for the work presented by witness Bozzo, which was, however, performed on a much more limited scope of activities. Possibly another five person years of effort would be required to complete the work. Tr. 27/13168-69. Furthermore, witness Bozzo has only estimated ten of the variabilities that witness Bradley estimated. In addition, there are a large number of BMC and non-MODS variabilities that have not yet been estimated. Finally, there are significant methodological issues in dispute over the work. Accordingly, witness Smith suggests that the Commission recommend that the Postal Service create a special working group to guide further analysis in this area. The atmosphere of a working group, in which technical issues can be discussed and resolved in a non-adversarial atmosphere, would be vastly superior to the limitations of litigation. Tr. 27/13170. As witness Smith testified, "I believe many of the more technical issues regarding the handling of the data and variables and the estimators could be substantially narrowed." Id.

H. In Conclusion, the Commission Must Retain for Now the Historical Approach of 100 Percent Volume Variability

As highlighted by witness Smith, the modifications to the Bradley model presented in Docket No. R97-1 by witness Bozzo for this proceeding neither make the fundamental adjustments the Commission previously said are necessary, nor do they provide adequate justification for accepting those aspects of the model previously rejected.

The model continues to include the following deficiencies:

- The database includes demonstrable errors not sufficiently tested and credible.
- The underlying data themselves are visually compelling, as demonstrated by witness Smith's testimony and Appendix, suggesting a volume variability approaching 100 percent.
- There is a need for major data verification efforts.
- The economic theory underlying the model does not substantiate the labor demand function used by witness Bozzo.
- The estimation approach is not substantiated. Given the current deficiencies in the work, the "between" model is more favorable than the time series fixed effects model.
- Major changes need to be made to the underlying process: specifications of output, consideration of the manual ratio, capacity utilization, investment, simultaneous equation issues, considerations of modeling at the system or plant level, and recognition of the interactions of activities.

- Witness Bozzo's model is short run and does not properly reflect the rate effective time period.
- Allied labor activities for which data are not available should not be modeled by proxy as proposed by the MPA group.

IV. THE COMMISSION SHOULD ACCEPT THE POSTAL SERVICE'S PROPOSED CITY CARRIER STREET TIME PROPORTIONS

Postal Service witnesses Raymond (USPS-T-11; USPS-RT-11) and Baron (USPS-T-12; USPS-RT-12) have presented new estimates of the street-time percentages used in the segment 7 cost analysis. These new percentages are based on an extensive Engineered Standards ("ES") study conducted by the Postal Service during the years 1996 through 1998. These two witnesses, along with supporting testimony submitted by witness Kent (NAA-RT-2), provide substantial evidence that the ES-based street-time percentages are reliable for ratemaking purposes and represent an improvement over the percentages derived from the 1986 Street Time Sampling ("STS") study and used in prior proceedings.

A. The New Engineered Standards Study Is an Improvement Over the Old STS Study

The primary intervenor witness arguing to exclude the use of the ES study data is witness Crowder (MPA-T-5). She asserts that the route sample and related street time tallies developed as part of the ES study are unreliable and not representative of the postal system of routes. Furthermore, she suggests that the data were collected and applied in such a way as to overstate the time spent by carriers loading mail. Tr. 32/16169-85.

An important part of her analysis is a review of ES videotape data collected during the ES study. Witness Raymond shows persuasively why witness Crowder's videotape analysis is flawed. For example, he explains how the taped segments of routes were not designed to serve as the basis for estimating load time, and in many cases are truncated and characterized by missing segments in the middle of a carrier activity. USPS-RT-11, p. 7. He also points out several instances of significant errors made by witness Crowder in reviewing and interpreting the tapes. For example, he asserts witness Crowder included in her time measurements tape sequences where the carrier is blocked from view or not observed at all. USPS-RT-11, p. 10.

Another important component of witness Crowder's argument is that witness Raymond incorrectly assigned certain tallies to the load category. MPA-T-5, pp. 17-19; Tr. 32/16211. Witness Baron shows how excluding these tallies from the dataset does not significantly affect the street-time percentages. USPS-RT-12, p. 44. He further illustrates the Postal Service's willingness to adjust the dataset in instances where witness Crowder's critique was merited. For example, the dataset has been adjusted to correct for biases concerning the distribution of possible deliveries in the ES database across delivery-type categories. USPS-RT-12, p. 45.

B. Witness Crowder's Perceived Concerns About the ES Study Are Overstated

Another weakness in witness Crowder's critique is her failure to develop a standard of comparison for determining whether the ES study should be used to develop street time percentages. In particular, she fails to compare the quality of the ES study and resulting data to the STS-based data used in prior proceedings. Witness

Kent provides compelling evidence that the ES study is an improvement over the STS study. For example, the ES study employed trained data collectors to record carrier activity every six minutes during a workday, while the STS study had carriers self-report their activities only three times over the course of a day. In addition, the ES database includes a larger sample of routes, extending over a longer survey period. Tr. 39/17877-88. These are important comparisons, because they successfully rebut critiques made by witness Crowder concerning the ES study.

V. THE COMMISSION SHOULD REJECT THE POSTAL SERVICE'S PROPOSED TREATMENT OF CITY CARRIER LOAD TIME COSTS

During this proceeding, witness Baron has proffered two evolving options for the Commission to consider in evaluating the volume variability of City Carrier Load Time and attributing related costs to specific subclasses of mail. The first option, submitted primarily through his direct testimony and modestly adjusted in rebuttal, argues for applying elasticities derived from the 1985 Load Time Variability ("LTV") study to the accrued load time costs derived from the new ES study, with adjustments to the established treatment to incorporate his notions of the "stops effect" and "deliveries effect." This option is identical to the proposal submitted by witness Baron in the R97-1 proceeding (with the exception of using the ES-based street time proportions), which the Commission rejected. The second option, introduced through various library references, interrogatory responses, and rebuttal testimony after witness Baron's and intervenor direct evidence were submitted, argues for applying elasticities derived from witness Baron's ES-based load time regression to the accrued load time costs derived from the ES study, while eliminating his stops effect adjustments. Witness Baron's

multiple proposals have created unnecessary complication and confusion surrounding the appropriate treatment of load time costs.

Table 3 summarizes the proposals proffered by witness Baron and the OCA's preferred treatment of load time costs. In addition, it compares these options to the approach employed by the Commission in the Docket No. R97-1 rate proceeding. As the table shows, the OCA offers a balanced approach, employing the same well-established methodology used by the Commission in R97-1 and prior proceedings to estimate volume variable load time costs and attribute residual coverage-related costs. The only proposed change from the established treatment involves using the new, ES-based, street time proportions and related accrued load time costs as the basis for the load time volume variability analysis, as discussed in the prior section. The reasons for which the Commission should reject other components of witness Baron's proposed options are discussed below.

		Tal	ole 3					
SUMMARY OF OPTIONS FOR LOAD TIME TREATMENT								
Options	Basis for Accrued Load Time Costs	Stops Effect Adjustment	Derivation of Elemental Load Time	Attribution of Residual (coverage-related)				
Baron: Option 1	ES study	Include	Use LTV-based elasticities	None; treat as institutional cost				
Baron: Option 2	ES study	Exclude	Use ES-based elasticities	None; treat as institutional cost				
OCA Preferred	ES study	Reject	Use LTV-based elasticities	Attribute based on single subclass stop ratios				
PRC: R97-1	STS study	Rejected	Used LTV-based elasticities	Attributed based on single subclass stop ratios				

A. Witness Baron's Analysis of City Carrier Load Time Volume Variability Is Flawed

Witness Baron's options for the load time variability analysis are inconsistent with several components of the established treatment of segment 7 costs. His first option is identical in substance to his proposal in Docket No. R97-1, which was wholly rejected by the Commission. His second option employs elasticities derived from a regression generated using data from the ES study. This regression differs significantly from the established LTV-based regressions, was not presented in the Postal Service's direct case, and has not been sufficiently reviewed in the record of this proceeding. Thus, it is not yet ripe for use for ratemaking purposes. Finally, in both of these options, witness Baron excludes the use of single subclass stop ratios to attribute non-elemental load time. This approach strays from the Commission's well-established approach.

1. Witness Baron's "Stops Effect" is arbitrary and unfounded

In his direct testimony, Postal Service witness Baron proposed that a portion of load time be treated as "fixed time at a stop." This portion of load time (amounting to

\$260 million) would then be reallocated to the access component of carrier street time. In Docket No. R97-1, the Commission specifically rejected this approach, concluding that the stops effect concept is theoretically flawed. PRC Op. R97-1, ¶¶ 3276-78. Based upon review of the relevant testimony and supporting data, OCA witness Mark Ewen (OCA-T-5) concurs that the proposed stops effect approach is not justified and urges the Commission to again reject this approach. Tr. 25/12042, II. 12-15.

In rebuttal, witness Baron attempts to salvage his fixed time at stop measure by making certain adjustments to his estimation methodology. USPS-RT-12, pp.12-22. Specifically, he abandons his use of the bottom quintile of observed one-letter load times by stop type from the LTV study, conceding this approach is arbitrary and results in a measure of fixed stop time that is greater in many instances than total load times at stops receiving two or more pieces of mail. USPS-RT-12, p. 14. In the place of this measure, he uses the minimum one-letter load times measured at stops with various receptacle and container type combinations. He then weights each of these load times by the percentage of all one-letter load time tests for each receptacle-container type category and sums these time estimates to derive a weighted average of minimum observed load times. USPS-RT-12, p. 15. Witness Baron argues this approach is an improvement because it eliminates the arbitrary selection of the bottom quintile of load times and better accounts for the effect of receptacle and container type on fixed stop time. USPS-RT-12, p. 19.

Witness Baron's claim that these adjustments are an improvement over his initial approach are not persuasive. Most important, and despite his mechanical adjustments, the stops effect concept remains a fictional construct founded upon an incorrect

interpretation of prior Commission opinions. Additional justification offered for the approach is based on a strained and unnecessary extension of the activity-based functional approach for allocating total street-time among the major carrier activities into the assessment of load-time volume variability. Furthermore, witness Baron continues to make use of LTV data that do not directly measure the effect, nor do the results of the load-time regression equations provide a hint that carriers might spend some fixed amount of time at each stop. 168 Furthermore, even if one accepts witness Baron's notion of the stops effect, the use of minimum total load times still represents an incorrect measure, since they must, by definition, overstate fixed time at stop, under his definition thereof. Finally, although witness Baron purports to capture the effects of receptacle and container type on fixed stop time, his method does not capture other non-volume factors that likely influence load time, like weather, time of day, and a host of other potential factors. 169 As a result, the Postal Service's analysis of the stops effect is neither theoretically nor empirically supported. For these reasons, witness Ewen recommends that the Commission maintain its established treatment of load-time costs. Tr. 25/12032-43.

Interestingly, witness Baron's adjusted fixed time at stops measure actually increases for MDR and BAM stops compared to his original measure, suggesting a larger portion of total load times at these stops are equal to or less than the fixed time amount.

The impact of these factors should be embedded in the intercept term of the load time regressions.

2. The ES-based regressions are untested and should not be used to estimate elemental load time

After the filing of his direct testimony, witness Baron provided a second option for conducting the load time volume variability analysis. In this option, introduced in certain library references (USPS-LR-I-310, -386, -402) and discussed in his responses to certain interrogatories (UPS/USPS-T12-21) and in his rebuttal testimony (USPS-RT-12), witness Baron suggests the LTV regressions should be abandoned in favor of a new regression based on data from the ES study. Although the OCA agrees that it would be desirable to update the LTV regressions, which are based on 1985 data, it is clear from the record, or lack thereof, that it is not appropriate at this time to employ the ES-based regression to estimate load time volume variability.

The primary reasons for rejecting the ES-based regression option include:

- ◆ The Postal Service itself did not employ the ES-based regression in its direct case. Curiously, the Postal Service made no mention of the ES-based regression in the relevant testimony of its witnesses, nor did it imply that the ES data could be used to estimate such regression equations. Only in response to certain interrogatories did the Postal Service note the existence of such a possibility. The late arrival of the ES-based regression casts considerable doubt concerning whether the Postal Service had sufficient time to develop and analyze the regressions before their submittal.
- ◆ The record is thin. As a result of the Postal Service's delay, the ES-based regression has received little review by other intervenors in this proceeding. Indeed, even the primary intervenor witness advocating for its use, witness Crowder, admits that she has not investigated the ES model thoroughly nor considered possible alternative specifications. Tr. 32/16224.
- ◆ The ES-based regression is based on route level data; the LTV regressions are based on stop level data. This difference is important because we know from the LTV regressions that stop level characteristics, and their interaction with mail volume, have significant impacts on load time. It is uncertain whether a route level regression can appropriately capture

these stop level influences in the variability analysis, nor has this issue been appropriately investigated on the record in this proceeding.

- ◆ The underlying ES data appear to require considerable manipulation to generate "believable" regression results. For example, the original specification of the model and related data produced nonsensical results, and required the inclusion of dummy variables to control for a subset of route level, volume-to-load time, observations that varied significantly from the rest of the sample. USPS-LR-I-310, pp. 7-9. The Postal Service has also filed two subsequent library references (USPS-LR-I-402 and USPS-LR-I-386) to document further adjustments made to the regressions as a result of additional problems with the original specification and underlying data.
- ◆ The elasticities derived from the ES-based regression are likely based on incorrect volume data. The established approach for deriving elasticities from the LTV regressions uses the most recent average stop level volume data from the CCS. To derive elasticities using the ES-based regression, the Postal Service employs average route level volume data from the ES study. The ES data, collected during the years 1996 through 1998, are quickly becoming out of date. In addition, it is uncertain how available CCS stop level volume data, for this and future proceedings, can be adjusted to route level data, and applied to the ES-based regressions to derive updated load time elasticities. Witness Crowder recognizes this point, conceding that load time elasticities should be calculated using up-to-date volume data, and that the current CCS volume data "need to be converted to the appropriate average route volume measures to calculate the shape-related variabilities." Tr. 32/16224.

These factors demonstrate persuasively that the ES-based regression is not ripe for application in this proceeding. Furthermore, the OCA sees no reason why it would be analytically improper for the Commission to the apply the LTV-based elasticities to the ES-based accrued load time costs to estimate elemental load time. The Postal Service took this very approach in its direct case. In addition, the Commission has long applied the LTV-based elasticities to accrued load time estimates derived from a separate study, the Street Time Sampling survey. Although the LTV and ES studies

are separated by a longer time span, the use of these two studies in tandem is preferable to applying the untested, ES-based, elasticities.

 Witness Baron's approach ignores the appropriate application of single subclass stop ratios to attribute coverage-related city carrier load time

After estimating elemental load time (using either the LTV or ES-based regressions), witness Baron treats the residual component, commonly referred to as coverage-related load-time, as an unattributable institutional cost. This treatment differs from the Commission's established approach of attributing coverage-related load-time costs based on the proportion of mail delivered to single-subclass stops ("SSS"). In fact, the Commission rejected witness Baron's treatment of the residual component of load time as an institutional cost in Docket No. R97-1, and attributed this component using SSS ratios.

The justification for using the SSS methodology to attribute non-elemental load time has a long history in postal ratemaking proceedings.¹⁷⁰ The Commission has maintained that it has a statutory duty to attribute costs when their causation can be reliably identified. *Id.* ¶3147. Costs incurred to deliver a single subclass of mail at a stop qualify as such costs. In fact, witness Baron recognizes the causality between stops receiving one subclass of mail and the costs incurred to deliver that mail, conceding that single subclass stops for a particular subclass would not occur if that

¹⁷⁰ See, e.g., PRC Op. R94-1, ¶¶ 3095-3152.

subclass did not exist. Tr. 42/18764. Accordingly, the SSS approach is entirely defensible and appropriate and should be employed again in this proceeding.

B. The Commission Should Attribute the Costs of City Carrier Load Time As It Did in Docket No. R97-1

The record in this proceeding provides a clear and reasonable approach for the load time variability analysis. This approach includes the following components: (1) use the accrued load time costs developed from the ES-based carrier street time proportions as the basis for the load time analysis; (2) reject any adjustment or reduction in these costs based on the Baron "stops effect;" (3) apply the elasticities from the LTV regressions to estimate elemental load time; and (4) attribute residual load time costs after elemental costs have been estimated (*i.e.*, coverage-related costs) based on the proportion of mail volumes delivered to single-subclass stops. This approach combines the use of updated and fully-reviewed street time percentages and related accrued load time costs with the application of well-established methods for assessing the volume variability of these costs.

VI. THE FIRST-CLASS, FIRST-OUNCE RATE SHOULD REMAIN AT 33 CENTS

The OCA proposes that the current 33-cent rate for single-piece First-Class Mail be retained in order to reduce the growing institutional cost burden on the First-Class Letter Mail subclass.¹⁷¹ The testimony of OCA witness Callow shows that First-Class Letter Mail has been carrying an increasing burden of the institutional costs of the

The Postal Service also proposes to raise the additional ounce rate from 22 to 23 cents. If the Commission recommends retention of the current 33 cent basic first-ounce rate, the OCA has no objection to the Commission recommending an increase in the additional ounce rate.

Postal Service.¹⁷² Using virtually any measure of institutional cost, the institutional cost burden borne by First-Class Letter Mail has risen during the past 12 years, and has become more prominent recently. The growth in institutional costs has occurred as the cost of First-Class Letter Mail has declined. Similarly, the institutional cost burden on First-Class Letter Mail has increased relative to the institutional cost burden on commercial Standard Mail.

The institutional cost burden on First-Class Letter Mail has also grown relative to the institutional cost burden intended by the Commission, as expressed in several recent recommended decisions. Consequently, the Commission should retain the single-piece First-Class rate at 33 cents in order to provide the most benefit to individual and smaller mailers, to reduce the institutional cost burden on First-Class Letter Mail, and to enhance fairness and equity. Moreover, retaining the 33-cent single-piece rate is possible in this proceeding, in combination with the "as-filed" methodology for forecasting the number of single-piece additional ounces per piece in the test year, among other OCA proposals.

A. First-Class Letter Mail Is Bearing an Increasing Institutional Cost Burden of the Postal Service

The institutional cost burden on First-Class Letter Mail is high, and has been rising in recent years. This conclusion is based on an analysis of Postal Service revenue and cost data that is used to calculate several common measures of institutional cost burden.

¹⁷² See Tr. 22/10104-27.

1. The increasing institutional cost burden on First-Class Letter Mail is evident using virtually any measure of institutional cost

Witness Callow demonstrates the extent of the increasing institutional cost burden on First-Class Letter Mail using several measures of institutional cost burden: the cost coverage, the mark-up index and the cost coverage index. The First-Class Letter Mail cost coverage, while traditionally higher than the "systemwide" average cost coverage for all mail, has risen significantly during the past 12 years compared to the systemwide average. Table 1, and accompanying Figure 1, in witness Callow's testimony compares the First-Class Letter and systemwide average cost coverage. Tr. 22/10106. In the period FY 1988 through FY 1999, the First-Class Letter cost coverage has risen from 162 percent to 197 percent, compared to an advance in the systemwide average from 149 percent to 168 percent. Id. In two fiscal years during this period, FY 1997 and 1998, the First-Class Letter cost coverage exceeded 200 percent, reaching 205 and 209 percent, respectively. To put this rapid advance in the cost coverage into perspective, from FY 1988 to FY 1996 the First-Class Letter Mail cost coverage rose gradually from 162 percent to 175 percent. In the test year, the Postal Service proposes to preserve the high First-Class Letter Mail cost coverage at 197 percent—the same cost coverage for First-Class Letter Mail as in FY 1999. Id.

The rising institutional cost burden on First-Class Letter Mail is also evident when considered on a per piece basis. See Tr. 46E/22009, OCA Cross-Examination Exhibit, OCA/USPS-RT-19-XE-1. During cross-examination on rebuttal concerning the exhibit, witness O'Hara confirms that attributable costs per piece for First-Class Letter Mail have remained nearly constant, Tr. 46E/22001, while the contribution per piece has increased about 75 percent "in nominal terms." Tr. 46E/22006-07. In "real" terms, the contribution per piece has increased even more. Tr. 46E/22007.

Measuring the institutional cost burden via a mark-up index or a cost coverage index also reveals a rising burden on First-Class Letter Mail. Table 2 and Figure 2 in witness Callow's testimony shows the mark-up index for First-Class Letters. Tr. 22/10107. During the 12 year period FY 1988 through FY 1999, the mark-up index for First-Class Letters rose from 1.256 to 1.439. *Id.* In more recent years, the mark-up index shows a more rapid rise in the institutional cost burden on First-Class Letter Mail, increasing from 1.169 to a high of 1.439 during the five year period beginning in FY 1995. In the test year, the mark-up index number of 1.422 is higher than the mark-up index for all but two of the preceding 12 years. *Id.*

A review of the First-Class Letter cost coverage index reveals a similar change. Table 3 and Figure 3 in witness Callow's testimony shows, like the mark-up index, an increasing institutional cost burden on First-Class Letter Mail, using the cost coverage index. Tr. 22/10109. Based upon reported data, the cost coverage index for First-Class Letters grew from 1.084 in FY 1988 to 1.177 in FY 1999, and is expected to rise still higher in FY 2000. *Id.* As with the mark-up index, the First-Class Letter cost coverage index shows a steady rise from 1.065 to 1.177 beginning with FY 1995 through FY 1999. *Id.*

2. The institutional cost burden on First-Class Letter Mail is increasing relative to the institutional cost burden on Standard (A) Mail

First-Class Letter Mail has long contributed more in absolute terms to the institutional costs of the Postal Service than the next largest class of mail, Standard (A)

Mail. 174 Over time, the relative share of institutional costs contributed by First-Class Letter Mail has grown relative to the share contributed by commercial Standard (A) Mail, and the "gap" has widened in recent years. Table 6 and accompanying Figure 6 in witness Callow's testimony compares the First-Class Letter and commercial Standard (A) Mail mark-up indices to the total average mark-up index for all mail classes and services. Tr. 22/10114. Table 6 reveals the widening gap in the relative institutional cost contribution of First-Class Letters and commercial Standard (A) Mail in recent years. For the five year period beginning in FY 1995, the First-Class Letter mark-up index rose steadily from 1.169 to 1.439, while the commercial Standard (A) Mail mark-up index reveals an overall decline from 1.080 to 0.828. *Id.* Moreover, during FY 2000 and 2001, the commercial Standard (A) Mail mark-up index is expected to decline further, ending at 0.777. *Id.* By contrast, the First-Class Letter mark-up index is expected to rise still higher to 1.469 in FY 2000, and then decline in the test year to 1.422. *Id.*

A similar relative change is evidenced using the cost coverage index. Table 7 and Figure 7 in witness Callow's testimony compare the First-Class Letter and commercial Standard (A) Mail cost coverage indices to the cost coverage index for all mail. Tr. 22/10115.

In his testimony, witness Callow refers to the commercial subclasses in Standard Mail—Regular and ECR—as "Standard (A) Regular." This represents a "shorthand" reference, since witness Callow combines revenues and costs for the commercial subclasses for three years, FY1997, 1998 and 1999, out of the twelve years presented in his analysis. Tr. 22/10202. Doing so permits a "consistent measure of revenues and costs for [the] commercial mail" subclasses in order to compare whether "the largest volume subclasses in First-Class and Standard Mail should have roughly equivalent markup indices." See PRC Op. MC95-1, ¶1019.

B. The First-Class Letter Mail Institutional Cost Burden Has Exceeded That Intended by the Commission

It is clear that the rising institutional cost burden on First-Class Letter Mail during the period FY 1988 through FY 1999, and at an accelerating rate in recent years, has produced substantial additional revenues for the Postal Service. More significantly, the additional revenue contributed by First-Class Letter Mail to the Postal Service's institutional costs has exceeded the revenue contribution intended by the Commission.

 Commission opinions reveal an intention to have the cost coverage for First-Class Letter Mail and the commercial Standard Mail subclasses close to the systemwide average

In several rate and classification proceedings, Commission opinions have made repeated and consistent statements concerning the proper relationship of the cost coverage of First-Class Letter Mail to the systemwide average cost coverage. The Commission has also considered the proper relationship between First-Class Letter Mail and commercial subclasses in Standard Mail.

In Docket No. R87-1, the Commission stated its "general goal" that the "First-Class cost coverage should be close to the systemwide average." PRC Op. R87-1, ¶4026. Subsequently, in Docket No. R90-1, the Commission, in commenting on its recommended rates in Docket No. R87-1, expressed the view that the resulting

coverage for First-Class was too high, and the coverage for third-class was too low. Thus the initial issue that we must address is bringing this relationship back into proper balance, by bringing the coverages for First-and third-class closer together, near the systemwide average. PRC Op. R90-1, ¶4055.

Similarly, in Docket No. R94-1, the Commission stated that it "continues to believe that setting target coverages [for First-Class and third-class] reasonably near

the systemwide average represents the best accommodation of the section 3622(b) factors." PRC Op. R94-1, ¶4041.

Finally, in Docket No. MC95-1, the Commission repeated its view on the proper relationship between First-Class and commercial Standard Mail at the time it established an additional subclass in Standard Mail. Accordingly,

The Commission has expressed its reluctance to shift too large a share of the total institutional cost burden to First-Class in several recent omnibus rate cases. [citations omitted] . . . The Commission's willingness to establish an additional subclass within Standard Mail should not be interpreted as a retreat from the view that the largest volume subclasses in First-Class and Standard Mail should have roughly equivalent markup indices. PRC Op. MC95-1, ¶1019.

These expressions of Commission intent have been contradicted by the reality of Postal Service costs and revenues, as shown in actual mark-up indices. Given these expressions, it is clear that the systemwide average and the Commission's recommended mark-up indices are measures against which actual results can be judged. There is no doubt that the institutional cost burden on First-Class Letters has exceeded that intended by the Commission, and that the commercial Standard Mail institutional cost burden is less than intended.

 The actual mark-up index for First-Class Letter Mail is higher than intended by the Commission, while the actual mark-up index for commercial Standard Mail is lower than intended

Witness Callow compares the mark-up and cost coverage indices computed from actual cost and revenue data to the Commission's recommended mark-up and cost coverage indices from Docket Nos. R87-1, R90-1, R94-1 and R97-1. The actual mark-up cost coverage indices for each year are compared to the recommended mark-

up and cost coverage indices from each case in the years in which the rates were in effect. These rate changes cover a 12 year period, from FY 1988 through FY 1999. FY 1988 is the starting point for witness Callow's analysis—the year in which rates recommended in Docket No. R87-1 became effective. FY 1988 was selected because it was in Docket No. R87-1 that the Commission expressed concern about departing from its "general goal" of having the First-Class cost coverage close to the systemwide average.¹⁷⁵

Table 4 and Figure 4 of witness Callow's testimony present the actual First-Class Letter mark-up index compared to the recommended First-Class Letter mark-up index obtained from the four Commission opinions issued during the 12 year period. Tr. 22/10111. The First-Class Letter mark-up index is also compared to the average recommended First-Class Letter mark-up index calculated for the four Commission opinions.

During the 12 year period, FY 1988 through FY 1999, the actual First-Class Letter mark-up index is higher than the recommended index for all but three years. When compared to the average First-Class Letter mark-up index, the actual First-Class Letter mark-up index remains above the average index for all but five of the 12 years from FY 1988 through FY 1999. *Id*.

Table 5 and Figure 5 of witness Callow's testimony also show that, during the same 12 year period, the actual First-Class Letter cost coverage index is above the recommended index for all but two years. Tr. 22/10111-12. By comparison to the

¹⁷⁵ PRC Op. R87-1, ¶4026; see also PRC Op. R90-1, ¶4055.

average First-Class letter cost coverage index, the actual First-Class Letter cost coverage index remains above the average index for six of the 12 years from FY 1988 through FY 1999. It is clear both Figures 4 and 5 show a dramatic rise in the mark-up and cost coverage indices, respectively, after 1996.

Witness Callow also shows, by comparing the actual First-Class Letter and commercial Standard Mail mark-up indices to the recommended mark-up indices, a widening gap in the relative contributions by First-Class Letters and commercial Standard Mail. This comparison is presented in Table 8 and accompanying Figure 8 in witness Callow's testimony. Tr. 22/10116. The actual First-Class Letter mark-up index roughly tracks, albeit somewhat higher, the recommended index until FY 1994, falling below the recommended index for three years. From FY 1995 through FY 1999, the actual First-Class Letter mark-up index increases, rising above the recommended index during the last three fiscal years. *Id.* The actual First-Class Letter mark-up index follows a similar pattern vis-a-vis the average mark-up index. By contrast, the actual commercial Standard Mail mark-up index remains below the recommended index for all but five years, FY 1994 through FY 1998, and then returns below the recommended index in FY 1999. *Id.* The actual commercial Standard Mail mark-up index follows the same pattern by comparison to the average mark-up index.

3. First-Class Letter Mail has contributed revenues in excess of the amount intended by the Commission

The comparison of actual mark-up indices to the Commission's recommended mark-up indices reveals the years in which First-Class Letter Mail has made contributions to institutional costs greater than intended by the Commission. Witness

Callow gives concrete meaning to this excess contribution in relation to the Commission's stated "preference." Table 11 in witness Callow's testimony quantifies in dollar terms the First-Class institutional cost burden in excess of that intended by the Commission. Tr. 22/10121. Witness Callow averages the First-Class Letter Mail mark-up index from all four proceedings to produce a "benchmark," and estimates the excess revenue contributed by First-Class Letter Mail to institutional costs. Witness Callow considers this average "benchmark" to be close to the systemwide average, rather than using the systemwide average itself as the "benchmark," even though it has been the Commission's stated goal to equalize cost coverages for First-Class Letter Mail and the commercial subclasses of Standard Mail close to the systemwide average.

Based upon the First-Class Letter Mail mark-up index "benchmark," First-Class Letter Mail has contributed net additional revenues in the amount of \$6.8 billion to the institutional costs of the Postal Service during the 12 year period FY 1988 to FY 1999. Id. Through the test year, the total net additional revenue is expected to reach \$11.2 billion. Id.

Using a mark-up index average as the "benchmark" for measuring the excess contribution of First-Class Letter Mail is not the only way to show the impact on First-Class Mail. Using the Commission's recommended mark-up index for First-Class Letters of 1.200, 1.235, 1.310 and 1.308 from Docket Nos. R87-1, R90-1, R94-1 and R97-1, respectively, instead of the average "benchmark," also shows a large excess institutional cost contribution for First-Class Letters. Table 4 below shows the excess to be \$6.3 billion in the period FY 1988 through FY 1999, and \$9.7 billion through the test year.

TABLE 4

ANNUAL CONTRIBUTION TO INSTITUTIONAL COSTS BY FIRST-CLASS LETTERS
IN EXCESS OF COMMISSION RECOMMENDED FIRST-CLASS MARK-UP INDICES

(amounts in millions)

(amounts in minoris)																
1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999		nated 2001		otal 1988-2001	
\$294	\$907	\$1,248	\$727	\$925	\$ 919	\$348	(\$1,221)	(\$841)	\$117	\$1,292	\$1,505	\$2,229	\$1,210	\$6,218	\$9,657	

C. There Is No Cost Basis To Increase the First-Class Letter Mail Rate

Traditionally, increasing attributable costs for a mail class or service are an important justification for increasing postal rates. With respect to First-Class Letter Mail, attributable costs have exhibited a continuous decline as a percent of total costs in recent years. Consequently, the Postal Service's proposed rate increase and higher institutional cost burden on First-Class Letter Mail in this proceeding cannot be justified. Retaining the single-piece First-Class rate at 33-cents would reverse the trend toward a higher institutional cost burden, and recognize that the Postal Service's letter automation programs have reduced the costs of handling this mail.

The Postal Service's proposed increase in the rates for First-Class Letters is not justified by reference to Postal Service costs for First-Class Letters. Costs for First-Class Letter Mail as a share of total postal costs have declined during the period covered by this analysis.¹⁷⁶ Moreover, the decline has accelerated in recent years.

Witness Callow shows in Table 12 and accompanying Figure 10 that the First-Class Letter Mail attributable costs as a percentage of the total have declined from

Tr. 22/10125. The decline in First-Class letter mail costs is confirmed by a separate analysis prepared by the Postal Service at the request of the Commission. That analysis shows unit mail processing (and city carrier in-office activity) costs for First-Class letter-shaped mail declining over the entire 11 year period between 1989 and 1999. See Response of Postal Service Witness Smith to Presiding Officer's Information Request No. 4, March 17, 2000, Question 1, Attachment at 1.

52.98 percent to 45.71 percent during the 12 year period from FY 1988 through FY 1999. Tr. 22/10125. First-Class Letter attributable costs are expected to decline still further, to 44.99 percent in the test year. Moreover, the decline in First-Class Letter attributable costs is most apparent in recent years. Since FY 1995, First-Class Letter Mail costs have declined continuously from 53 percent and are expected to be 44.99 percent of total postal costs in the test year. And, it is clear that advances in the automation of letter-mail processing have restrained costs for workshare and single-piece mail. Tr. 46/22013.

D. Retaining the Current 33-Cent Rate in Order To Reduce the High Institutional Cost Burden on First-Class Letter Mail Meets the Pricing Criteria of the Act

The increasing institutional cost burden on First-Class Letter Mail should be reversed by maintaining the single-piece First-Class rate at 33 cents. Doing so would provide the most benefit to individual and smaller mailers, and restore a measure of equity to all First-Class Mailers. It would also recognize that the First-Class Letter institutional cost burden has grown in absolute terms—and relative to commercial Standard Mail—and has departed further from the Commission's stated goal of maintaining cost coverages for those subclasses roughly near the systemwide average.

The first pricing criterion in Section 3622(b) of the Postal Reorganization Act requires that consideration be given to the establishment and maintenance of a fair and equitable rate schedule. The placement of the "fairness and equity" criterion as the first of nine criteria suggests its importance in establishing rates. Simple fairness suggests that the institutional cost burden for First-Class Letter Mail be reduced. Maintaining the

current 33-cent single-piece First-Class rate would achieve that end, and is possible in this proceeding. Moreover, a brief review of the other eight pricing criteria suggest that retaining the 33-cent single-piece rate is consistent with the Act.

1. Reducing the high institutional cost burden on First-Class Letter Mail would enhance fairness and equity

The current 33-cent rate is certainly fair and equitable as it would result in a mark-up index much higher than the historical mark-up index suggested by the Commission. In the test year, the First-Class mark-up index at the current single-piece rate would be 1.524, Tr. 22/10175, compared to the Commission's recommended First-Class Letters mark-up index of 1.308. Even in the test year after rates, using OCA costs, the 33-cent single-piece rate would result in a mark-up index of 1.353. Tr. 22/10122. Consequently, retaining the current 33-cent single-piece rate results in a higher mark-up index than implied by application of the historic mark-up index recommended by the Commission in Docket No. R97-1.

Moreover, the current lawful rate is presumptively fair and equitable, as it is the same rate recommended by the Commission and approved by the Governors in Docket No. R97-1. Given the declining costs of handing First-Class Letter Mail as a percent of total costs, restraining the 33-cent basic rate is fully justified. In addition, the consistency of the current single-piece rate with the criteria of Section 3622(b) has not been contested. Tr. 22/10177.

2. The current 33-cent rate comports with the other pricing criteria of the Act

Section 3622(b)(2) of the Act requires consideration of the "value of service" actually provided to mailers and recipients (criterion 2). It is clear that the 33-cent rate for First-Class Letter Mail reflects a high value of service, based upon its high mark-up. That high value of service will continue to be reflected at the current rate, since the mark-up for First-Class Letters will be even higher than the mark-up recommended by the Commission in Docket No. R97-1.

As required by the third criterion, retaining the current 33-cent single-piece rate not only covers the Postal Service costs of providing First-Class Letter Mail, but also makes a substantial contribution to institutional costs of the Postal Service. As shown above, using OCA costs, the 33-cent single-piece rate would result in a mark-up index of 1.353 in the test year after rates. Using Postal Service costs, the 33-cent rate would result in a cost coverage and mark-up index of 190.1 percent and 1.369, respectively, in the test year after rates. Tr. 22/10185.

Criterion four requires consideration of the effect of rate increases on entities that to some extent have competing interests: the general public, business mail users, and competitors. The general public would benefit from retaining the 33-cent rate since they rely on single-piece First-Class Mail to large extent for bill payments and personal correspondence, among other mail matter. Business mailers in First-Class would also benefit, both those using single-piece mail and workshare. Commercial Standard (A) mailers have an interest in a higher single-piece rate. Similarly, competitors have an

interest in a higher single-piece rate. But commercial Standard (A) mailers should not receive artificially low rates as a result of unfairly high rates for First-Class Letter Mail.

In the last two rate proceedings, costs for commercial Standard Mail have increased faster than systemwide average costs. Even under such circumstances, the Commission in Docket Nos. R94-1 and R97-1 addressed the impact on commercial Standard Mail by limiting the rate increases suggested by the higher costs. This also had the effect of moving further away from the Commission's stated "goal" or "preference" of having First-Class and commercial Standard Mail cost coverages and mark-ups equalized near the systemwide average. On balance, over the past 12 years, and in recent years, First-Class Letter Mail has been bearing more of the institutional cost burden of the Postal Service than the Commission has said is preferable. Even at a 33-cent single-piece rate, First-Class Letter Mail will have a higher institutional cost burden, and commercial Standard Mail will have a lower burden, than preferred by the Commission, based upon its recommended mark-up indices. At the least, however, the movement will be toward the systemwide average—a goal of the Commission. Retaining a 33-cent single-piece First-Class rate is a way to balance these competing interests.

Retaining the current 33-cent single-piece rate is also one way to slow diversion to electronic communications and bill paying—an alternative increasingly available to users of single-piece First-Class Mail. Convenience, of course, is one motivation causing people to use the Internet. A more targeted approach to retaining bill payment mail, such as OCA's CEM proposal, would also be helpful. As a practical matter, however, some people are on the "margin," and could be swayed to alternatives such

as the Internet by a higher single-piece rate. The number of people in this position are unknown. Clearly, however, increasing the single-piece rate is going in the wrong direction to slow diversion.

The sixth criterion directs attention to the degree of preparation of the mail. Witness Callow does not propose any changes in the structure of discounts for First-Class and, as such, this criterion is not a consideration for purposes of retaining the single-piece rate.

The current single-piece rate is straightforward and simple to understand, consistent with the seventh criterion. Simplicity would be maintained by retaining the current rate. From another perspective, holding the mark-up relationships constant at the levels recommended by the Commission in R97-1 would also maintain simplicity. However, even a 33-cent single-piece rate cannot accomplish this goal, given the reduced costs for handling letter mail.

The educational, cultural, scientific and informational ("ECSI") value of First-Class Mail is a consideration in setting First-Class rates, as required by criterion eight.

Retaining the single-piece First-Class rate would continue the role of First-Class Mail in promoting the ECSI value of the mail for the nation.

Criterion nine permits Commission consideration of such other factors as it deems appropriate. As is clear from the evidence in this proceeding, First-Class Letter Mail has borne a higher institutional cost burden, on balance, than intended by the Commission. As shown in Figure 4 of witness Callow's testimony, the institutional cost burden on First-Class Letters has exceeded that intended by the Commission, as measured by the Commission-recommended mark-up index, for all but three of the 12

years from FY 1988 through FY 1999. Tr. 22/10111. It would be appropriate for the Commission to consider this fact among the other factors in determining the contribution to institutional costs, pursuant to criterion 9. Tr. 22/10126.

3. Retaining the current 33-cent First-Class Letter rate is affordable

Retaining the 33-cent First-Class rate in order to reduce the high First-Class institutional cost burden, and to move toward equalizing the First-Class and commercial Standard Mail cost coverages and mark-ups near the systemwide average, can be achieved in this rate proceeding. If the Commission adopts the 33-cent rate in this proceeding, revenues for the entire First-Class Letter Mail subclass will be reduced by approximately \$1.076 billion. Tr. 22/10122. OCA proposes several options making retention of the current 33-cent rate possible. Providing a contingency for the Postal Service at one percent, as proposed by OCA, reduces the Postal Service's revenue request by \$1.007 billion. See Exhibit USPS-9A; see also Tr. 41/18303. OCA also proposes that the Commission adopt the "as-filed" methodology for forecasting the number of additional ounces per piece for single-piece First-Class Letter Mail in the test year. Doing so would preserve \$192.3 million of single-piece First-Class Letter revenue resulting from application of the revenue adjustment factors to correct the overpayment of single-piece postage in the Postal Service's revenue requirement, plus an additional \$27.1 million from single-piece cards and workshare mail. 177

See Notice of Inquiry No. 3, First-Class Revenue Adjustment Factor (RAF) Error and Additional Ounce Method Change, June 30, 2000, Table 1, at 2. OCA's reasoning for retaining the "as-filed" methodology for forecasting the number of single-piece additional ounces in combination with the correction related to the net overpayment of single-piece postage are discussed in Section VI.E., below.

While restraint in establishing the test year revenue requirement makes retention of the 33-cent basic rate feasible, the OCA recognizes that some increase in commercial Standard Mail rates will be required. However, this should be embraced, as it will represent a move toward equalizing the First-Class and commercial Standard Mail cost coverages and mark-up indices, as intended by the Commission, and is consistent with the pricing criteria of the Act.

OCA's proposal to retain the current 33-cent First-Class rate focuses, of course, on the single-piece user. The OCA also recognizes that the basic rate affects all other rates in the First-Class Letter subclass. The OCA takes no position, however, on the proper discounts for workshare mail. Tr. 22/10203.

E. The Number of Additional Ounces of Single-Piece Letter Mail Should Be Forecast Using the "As-Filed" Methodology

In this proceeding, the Postal Service presents two methodologies that produce conflicting results with respect to the forecast of the number of additional ounces associated with single-piece First-Class Letter Mail in the test year. The first (herein, the "as-filed") methodology recognizes the decade-long trend of an increasing number of additional ounces per piece for single-piece letters as the basis for forecasting additional ounces. The second (herein, "revised") methodology considers a short recent period showing a small change in the number of additional ounces per piece as indicative of a reversal of the long-term trend, and the basis for forecasting no increase in the number of additional ounces in the test year.

For the reasons stated below, the Commission should rely on the "as-filed' methodology to forecast the number of additional ounces per piece for single-piece

First-Class Letters in the test year. Moreover, Postal Service introduction of the "revised" methodology offset nearly \$192.3 million of First-Class revenue resulting from a necessary correction to include the net overpayment of First-Class postage in the revenue requirement. The "revised" methodology must be evaluated on its own merits — separate from the necessary correction of revenues. Should the Commission adopt the "as-filed" methodology, the resulting additional net revenue of \$192.3 million should be used for the benefit of single-piece mailers.

1. The "as-filed" methodology, unlike the "revised" methodology, properly reflects the long-term trend in the number of additional ounces per piece for single-piece letters

In response to the Commission's Notice of Inquiry No. 3, Postal Service witness Fronk posits the central issue of the notice as follows:

In estimating single-piece additional ounces in the test year 2001, which method is likely to do a better job—the revised method which reflects the empirical reality of the nearly three years (1998 through PQ3 2000) immediately preceding 2001, or the as-filed method which does not reflect the reality of 1999 and 2000 to-date. Tr. 34/16533.

Witness Fronk's formulation is slanted to reflect his view that "it is the three year period immediately preceding the test year that is more relevant to evaluating the additional ounce forecasting method." Tr. 34/16541. But witness Fronk is wrong. It is the long-term trend that is relevant when evaluating the additional ounce forecasting method. Postal Service emphasis on only short-term data as the basis for forecasting the number of additional ounces produces results not representative of the long-term trend.

(a) The long-term trend in the number of additional ounces per piece, and average weight per piece, is rising

The Commission's Notice of Inquiry (NOI) No. 3 reveals that the long-term trend in the number of additional ounces per piece for single-piece letters has risen during the period FY 1990 through FY 1999.¹⁷⁸ Attachment 4 in NOI No. 3 illustrates that in every year during this ten year period, the number of additional ounces per piece for single-piece First-Class Letters has increased. A similar trend is evident with respect to the number of additional ounces per piece for total First-Class Letters, as shown in Attachment 5. *Id.*, Attachment 5.

The rebuttal testimony of OCA witness Callow (OCA-RT-1) reveals the extent of the rising trend in Figures 1 and 2. Tr. 36/16887-88. Figures 1 and 2 replicate Attachments 4 and 5 of NOI No. 3. A linear regression line is fitted through the historical data for single-piece letters and total First-Class Letters, respectively. Tr. 36/16887-88. The slope of the regression line (and the equation) is positive, revealing an increase in the number of additional ounces per piece over time.

Witness Callow also demonstrates that the Postal Service's "as-filed" methodology results in a forecast for the number of additional ounces per piece for single-piece letters nearly identical to the long-term trend. At the request of the Presiding Officer, witness Callow projected the linear regression line in Figures 1 and 2 forward to the test year. The projected trend line tracks "almost exactly" the number of additional ounces per piece for single-piece letters forecast by the "as-filed" methodology. Tr. 46B/20593. According to witness Callow, "the 'fit' of the linear

See Notice of Inquiry, No. 3, First-Class Revenue Adjustment Factor (RAF) and Additional Ounce Method Change, June 30, 2000, Attachment 4.

regression line to the forecast produced by the 'as-filed' methodology for Fiscal Year 2000 and the TYBR appears to be the best of any two years during the entire period shown in Figure 1." *Id.* A similar result is present with respect to total First-Class Letters, where the linear trend line through the historical data also tracks very closely the number of additional ounces per piece forecast by the "as-filed" methodology. *Id.*

Witness Fronk attempts to minimize the rising trend by reference to the sharp increases in the number of additional ounces per piece between 1997-98 and 1994-95 shown in Attachment 4 to NOI No. 3. He claims that, if these two "large increases can be explained by historical events unlikely to occur between the base year and the test year, then additional support is provided for the revised method. . . ." Tr. 34/16542.

Postal Service efforts to explain the large increases between 1997-98 and 1994-95 miss the significance of Attachment 4. The existence of these large increases, marking a more rapid rise in the long-term trend, does not change the fact that the long-term trend is still upward. If the years with large increases are ignored, and only the other years are considered, the trend in the growth of additional ounces would still be positive; just not as great. Tr. 36/16902-03.

The increasing long-term trend in the number of additional ounces per piece is also consistent with the increase in the average weight per piece for single-piece letters. The Commission's Notice reveals an increasing average weight per piece for single-piece letters, shown in Attachment 2. The increase is apparent from a visual

inspection of Attachment 2, where the values for PQ3 in all but two years are higher than the preceding years.¹⁷⁹

Witness Callow's rebuttal testimony also examines the increasing average weight per piece for single-piece letters. In Figure 3, which duplicates Attachment 2 of NOI No. 3, a linear regression line is fitted through the quarterly historical data for single-piece letters. Tr. 36/16889. The increasing average weight per piece for single-piece letters is evident from the positive slope of the trend line.

Figure 4 of witness Callow's rebuttal testimony segregates the weight per piece data from Attachment 2 into two groups, with data in PQ3, 1990 through PQ2, 1997 in one group and data in PQ3, 1997 through PQ1, 1999 in a second group. Tr. 36/16890. Separating the data between PQ2 and PQ3 of 1997—the midpoint—coincides with the fairly sharp increase in the number of additional ounces per piece between 1997 and 1998, and permits a comparable analysis of the weight per piece data with the number of additional ounces per piece. Figure 4 shows that, while the trend in the average weight per piece for single-piece letters rises more rapidly in the period prior to PQ3, 1997, there nevertheless continues to be a positive, but smaller, increase from PQ3, 1997 through PQ1, 1999. *Id*.

In his response to NOI No. 3, witness Fronk states that "it is the trend in additional ounces per piece . . . rather than average weight per piece, that is more

See Notice of Inquiry, No. 3, First-Class Revenue Adjustment Factor (RAF) and Additional Ounce Method Change, June 30, 2000, Attachment 2.

directly related to revenue." Tr. 34/16542. Witness Fronk supports his statement by the following example:

... for a given volume, the average weight of single-piece mail weighing less than 1 ounce could hypothetically increase from 0.5 ounces to 0.7 ounces and the average weight of pieces weighing between 1 and 2 ounces could increase from 1.6 to 1.9 ounces. This would increase the average weight of the single-piece mail stream, but leave revenue unchanged since a first-ounce stamp would still cover the postage for a 0.7 ounce piece and an additional ounce stamp would still cover the postage of the second ounce. *Id*.

Witness Fronk's statement, while true, attempts to neatly separate the relationship between an increase in the average weight per piece and an increase in the number of additional ounces per piece. His example, hypothesizing an increase in the average weight of pieces within the same weight step, without an increase in the number of additional ounces per piece, suggests the behavior of presort mailers. That is, presort mailers may become more efficient in including more material within a mailing (thereby increasing the average weight) and yet keep the weight under the 1 ounce weight step. Tr. 34/16584. In effect, witness Fronk's example suggests a distribution that is tightly clustered around the mean (e.g., a small standard deviation), but "skewed" to the right.

The rebuttal testimony of witness Callow presents a different example, whereby an increase in the average weight per piece in one weight step can just as well increase the number of additional ounce pieces in next weight step. Tr. 36/16893. Figure 5 illustrates the example, one that is more representative of the distribution of additional ounces for single-piece letters. In fact, there is no evidence to suggest that the distribution of additional ounces for single-piece letters is different from Figure 5.

The First-Class Mail rate structure creates an incentive in which some mailers will seek to include as much matter as possible in a mailpiece without going over the next additional ounce weight limit in order to avoid paying additional postage. Tr. 36/16907. Presort mailers are much more likely to respond to such an incentive than single-piece mailers. Tr. 36/16907-08. Simply put, single-piece mailers are unlikely to behave in the manner described by witness Fronk in his example. His example suggests that single-piece mailers, knowing that their mailpiece weighs more than an ounce, but not knowing the exact weight, take it to a post office to be weighed. Upon finding that the mailpiece weighs more than an ounce, the single-piece mailer then adds more material to increase the weight of the mailpiece to as near as possible to the next ounce limit without going over. Tr. 36/16908. Such behavior is obviously implausible for single-piece mailers. It is more likely single-piece mailers are motivated simply to pay the postage for the mailpiece they have prepared so that the mailpiece can be delivered to its destination. Tr. 36/16908-09.

(b) The "revised" methodology ignores the long-term trend and results in an unrealistic forecast

Witness Fronk acknowledges that the "as-filed" methodology "may appear to be more consistent with the long-term trend in additional ounces." Not only does it appear more consistent, it is more consistent with the long-term trend in additional ounces.

Tr. 34/16533. Response of US Postal Service Witness Fronk to Notice of Inquiry No. 3, July 17, 2000.

As discussed previously, the number of additional ounces per piece for single-piece letter mail has exhibited positive growth every year since 1990. And, when the long-term trend in the number of additional ounces is projected forward to the test year, the forecast for the number of additional ounces per piece for single-piece letters resulting from the "as-filed" methodology tracks almost exactly the projected trend line.

Nevertheless, the Postal Service claims that the "revised" methodology should be adopted because "newly available 1999 data . . . indicate that the additional ounces per piece in th[e] 0-11 ounce weight range have remained almost constant between 1998 and 1999." Tr. 21/9180-81. In his response to NOI No. 3, witness Fronk maintains that "data in 1999 and 2000 confirm that no change in the long-standing traditional method [e.g., the 'revised' methodology] is necessary or appropriate." Tr. 34/16537 (emphasis added). As a result, witness Fronk's "revised" methodology produces zero growth for 2000 and 2001.¹⁸¹

Not only is this new position inconsistent with the historical trend of the past 10 years, but it ignores witness Fronk's own finding of positive, but smaller, growth in the number of additional ounces per piece in 1999, and in the "hybrid" year 1999/2000. Tr. 34/16538-39. Similarly, the forecast produced by the "revised" methodology, when compared to the trend line of the historical data projected forward to the test year, results in a forecast for the number of additional ounces per piece for single-piece letters far below the linear trend line. Tr. 46B/20593.

See Notice of Inquiry, No. 3, First-Class Revenue Adjustment Factor (RAF) and Additional Ounce Method Change, June 30, 2000, Attachment 4.

Moreover, with respect to total First-Class Letters, witness Fronk's use of the "revised" methodology results in a forecast of two years of negative growth in the number of additional ounces per piece. Since 1990, there have never been two consecutive years during which growth has been negative.¹⁸²

Witness Fronk maintains that the additional ounce data for 1998, 1999, and three quarters in 2000 lend support for use of the "revised" methodology for forecasting the number of additional ounces per piece. However, the two years of 1998 and 1999, and incomplete additional ounce data for 2000, is much too limited a time period to claim an end of the long-term trend. To the contrary, the continuing positive, but smaller, growth in the number of additional ounces per piece in recent years is consistent with the historical trend, which shows periods of smaller positive growth followed by periods of more substantial growth. For example, between 1990 and 1991, the annual percentage change in the number of additional ounces per piece was 0.2 percent. 183 A similar change of 0.6 percent occurred between 1993 and 1994. Id. Moreover, estimates of the number of additional ounces per piece are derived from sampling. Tr. 34/16582. The recent lower rate of growth in the number of additional ounces per piece may be nothing more than sampling error. Tr. 34/16582-83. Both these represent reasonable explanations for the slow down in the number of additional ounces per piece in recent years.

¹⁸² Id., Attachment 5.

See Notice of Inquiry, No. 3, First-Class Revenue Adjustment Factor (RAF) and Additional Ounce Method Change, June 30, 2000, Attachment 3.

2. Single-piece revenue resulting from correcting the overpayment of postage, and the "as-filed" methodology, should be used for the benefit of single piece mailers

The Postal Service changed its methodology for forecasting the number of additional ounces per piece at the same time that it made a necessary correction to account for the omission of the net overpayment of First-Class postage in its revenue calculation. Correcting that error increased total net revenue for single-piece First-Class Letter Mail by \$192.3 million. The Postal Service's simultaneous introduction of the "revised" methodology reduced net revenue for single-piece First-Class Letter Mail by \$172.2 million. The "revised" methodology is an obvious ploy to offset nearly all of the increase in net revenue of single-piece letters from the necessary error correction.

Witness Fronk considers the correction to include the net overpayment of First-Class postage in the revenue calculation, and the change in the forecasting methodology, to be "inseparable," going so far as to describe both as "errors." Tr. 34/16557. Such statements turn logic on its head. Correcting the net overpayment of postage is a necessary change to reconcile revenues obtained from the billing determinants with postage revenue from the Revenue, Pieces, and Weight report; that is, to account of the net overpayment of single-piece First-Class postage. By contrast, the "revised" methodology does more than rectify an omission or make a simple error correction. Rather, it represents a new methodology, introduced late in the

The Postal Service's correction of its revenue calculation to account for the net overpayment of postage was prompted by OCA interrogatory OCA/USPS-106(d). See Tr. 21/9178.

See Notice of Inquiry, No. 3, First-Class Revenue Adjustment Factor (RAF) and Additional Ounce Method Change, June 30, 2000, at 1.

course of this proceeding, that conveniently negates the necessary error correction. There is no necessary connection between correction of the net overpayment of postage and the change in the forecasting methodology now proposed by the Postal Service. The "revised" methodology therefore should be considered on its own merits, separate from the necessary correction of revenues to account of the overpayment of postage.

Assuming that the Commission adopts the "as-filed" methodology, the resulting \$192.3 million increase in the net revenue from single-piece letters for the overpayment of postage should be used for the benefit of single-piece mailers. The identified increase in net revenue is a consequence of the behavior of single-piece mailers. According to witness Fronk, much of the unexplained revenue is "most likely explained by single-piece mailers using first-ounce stamps for additional ounce postage." Tr. 34/16536.

Failure to credit this net revenue to single-piece First-Class Mail rates will cause the high and rising cost coverage for First-Class Letter Mail to rise further. Without rate relief, the effect of the postage overpayment would be to increase the cost coverage for First-Class Letter Mail from 197.1 percent to 197.5 percent. Maintaining the single-piece First-Class Letter rate at 33-cents, however, would both recognize that single-

The Postal Service contends that the "revised" methodology "is tikely to do a better job . . . [of] reflect[ing] the empirical reality of nearly three years (1998 through PQ3 2000) immediately preceding 2001" than the "as-filed" methodology. Tr. 34/16533. Response of US Postal Service Witness Fronk to Notice of Inquiry No. 3, July 17, 2000. For the reasons discussed earlier, this is not the case. The clear, longer-term trend is the more rational basis for forecasting the number of additional ounces in the test year.

piece mailers should get the benefit of the net overpayment of postage and would moderate the high cost coverage of First-Class Letter Mail.¹⁸⁷

VII. THE COMMISSION SHOULD RECOMMEND OTHER BENEFICIAL CHANGES FOR FIRST-CLASS MAIL

A. The Time Has Come To Give the Public a Discount for Mailing Automation Compatible Courtesy Reply Envelopes

The OCA hereby requests that the Postal Rate Commission again recommend to the Governors creation of a Courtesy Envelope Mail ("CEM") rate category. The OCA also requests that the Commission recommend a discount of three cents per piece. Although the Postal Service has stubbornly opposed the CEM classification proposal since 1987, the degree of inefficiency and injustice resulting from this intransigent opposition continues to rise with every passing case.

To recapitulate, a CEM piece is a First-Class automation-compatible reply envelope, prepared in a way that allows Postal Service processing equipment to route the piece to a barcode sorter for its first (and often only) sortation. Such pieces of mail are far less expensive for the Postal Service to process and deliver than the average First-Class piece. CEM pieces are mailed predominantly by households and small businesses; at present they pay the full First-Class rate. Because CEM pieces are so inexpensive, the implicit cost coverage at full rates is excessively high. In fact, CEM's

¹⁸⁷ See Tr. 22/10122-26.

The OCA requests recommendation of the same DMCS language recommended in Docket No. R97-1. PRC Op. R97-1, App. 2, pp. 9-10, § 221.25.

This is the same discount proposed for QBRM. The processing and delivery of QBRM are essentially the same as those of CEM. Tr. 23/10736-37 and Tr. 45/19822-23.

implicit cost coverage is now much higher than the 387 percent shown in Docket No. MC95-1.

1. The implicit cost coverage of CEM is approaching 1000 percent

The 1000 percent is *not* a typographic error. One *thousand* percent. CEM is so inexpensive for the Postal Service to process and deliver that it costs about one-fifth of what the average piece of First-Class Mail costs. Postal Service witnesses claim incredulity that a reply envelope could cost so little. But Christiansen Associates has told the Postal Service the same thing: reply envelopes cost the Postal Service less than four cents per piece. Tr. 21/9198-202.

The difference in cost between a CEM piece and the average First-Class piece has three sources. First, CEM is automation-compatible. It does not require remote barcoding and almost always avoids manual sortation. Second, because it is a reply mail piece, CEM does not require as many sorts as the average First-Class piece. Instead, it is held out early in the sortation process and combined with similar pieces to the same addressee. Tr. 45/19834-35. Third, it is highly probable that CEM pieces are delivered in bulk or picked up by the addressee. Tr. 45/19831-32. If the addressee picks up this mail, it requires no delivery and lowers Postal Service costs even more.

CEM was first proposed by the OCA in Docket No. R87-1. Subsequent proposals were made in Docket Nos. R90-1, MC95-1, and R97-1. In each case, the OCA demonstrated the low costs of processing and delivering CEM, and the Postal

¹⁹⁰ Tr. 11/4531; Tr. 45/19829 and 19831.

Service made the same tired arguments against CEM. The Commission disposed of each of the Postal Service's arguments and even provided \$33 million for the Postal Service to use in educating customers in the use of CEM.¹⁹¹

2. The Postal Service's Arguments Against CEM Rest on Fear, Loathing, and Hyperbole

Witness Miller presents the Postal Service's arguments against CEM. These arguments rely on unproveable and unlikely charges that CEM would generate unbearable complications, excessive revenue losses, and a devastating ride down the slippery slope of deaveraging. These arguments have fared poorly in the past and do not withstand scrutiny now.

(a) A CEM rate category would cause no more complication or confusion than does the existing Card subclass

In his rebuttal testimony Witness Miller raises the following objections to CEM.

A second major First-Class single-piece letter stamp would complicate the nation's mail system for everyone, particularly households. These complications include:

The fact that it will be difficult to develop a standardized CEM mail piece design, given the variation that currently exists among CRM mail pieces.

PRC Op. Docket No. R97-1, ¶5197.

Rather than reject CEM because of potential misuse by consumers or the need for certain adjustments by the Service and distributors, the Commission believes appropriate educational efforts should be undertaken. The Commission's adjustments and recommendations on this record provide \$33 million that could be used for these efforts. This amount is provided as a final adjustment in Appendix J. The Commission urges the Governors and the Service to develop an effective campaign to assist consumers and interested mailers in responding to the CEM initiative.

The fact that all mailers will probably not voluntarily modify their designs which, in turn, would segment the current CRM mail stream into two mail streams that exhibit the same cost characteristics.

The fact that varied CEM mail piece designs and noncompliance on the part of some reply envelope providers will result in confusion for single-piece mailers.

The fact that current stamp distribution methods, such as vending machines and consignment outlets, will not accommodate two stamps. The placement of multiple stamps in one booklet will not be a viable alternative because the Postal Service has no way to reliably forecast consumer demand for each stamp denomination. In addition, some parties will undoubtedly want to purchase only one of the two denominations. Therefore, it is possible that the Postal Service would have to manufacture and distribute three separate types of stamp booklets: regular stamps, CEM stamps, and a combination of regular/CEM stamps.

The fact that it will be necessary to print a greater total number of stamps - in multiple denominations - than would otherwise have been required.

The fact that some single-piece mail users will have to make more frequent trips to their preferred stamp distribution outlets and/or change their preferred outlet.

The fact that it may someday be necessary to use multiple "make up" stamps during the time when new rates are implemented.

Tr. 45/19652-53. All of these objections evaporated during cross-examination.

(i) <u>Standardized mailpiece design—a nonissue</u>

Witness Miller's standardization argument is nonsense. CEM pieces are already standardized to the extent necessary for proper mail processing. The Postal Service successfully processes billions of pieces of prebarcoded mail, among them the courtesy reply envelopes that would become CEM pieces. As for informing consumers and postal revenue protection personnel that a mailpiece is eligible for the CEM discount, it was established on cross-examination

that the FIM would do the job of informing Postal employees that the piece was automation compatible and . . . that the message up there where the stamp goes would be sufficient to inform customers.

Now what else needs to be done in terms of mail piece design?

[Pause.]

THE WITNESS: As I was saying, based on your proposal, I mean there are some other issues related to reply envelopes that people do get that don't have barcodes or—I just, as I was saying, I mean this wasn't something that was in the original proposal and I would just need to get—I would feel more comfortable having time to give this more thought.

Tr. 45/19785-86.

The "confusion" argument proceeds along the same lines as the standardization argument. The Postal Service seems to believe that only large mailers possess the intelligence to determine when to apply discount postage. The general public, it believes, are uneducable—or worse; they are larcenous. The Postal Service seems to think individual mailers are willing to put a CEM stamp on a mailpiece that does not qualify for the discount even though that means the mailpiece may not reach its destination. No one making a bill payment would do anything of the sort. The late charges on the bill would certainly amount to more than three cents.

(ii) Multiple stamps and multiple trips—and preventing consumer choice

Witness Miller's argument concerning the inability of the Postal Service to sell two denominations of stamps in nonpostal retail outlets and in some of its vending machines did not withstand cross-examination. Witness Miller claimed that people would be unhappy if a CEM stamp existed and their primary distribution channel did not carry it. Tr. 45/19796. However, witness Miller seemed unconcerned that customers who would be willing to utilize a different outlet for CEM stamps are being denied that

choice entirely by the Postal Service's unwillingness to adopt CEM. And he could not explain why there were no complaints from customers who wanted to buy postcard stamps at nonpostal retail outlets. Tr. 45/19796-97. One interesting exchange concerning post cards appears at Tr. 45/19797:

Q So you haven't thought about the fact that postcards has its own subclass and it's smaller in volume terms than courtesy reply envelopes?

A I hadn't looked into that.

Witness Miller argued that CEM will add complexity to the rate schedule, yet he can see no problem with having a subclass of postcards which is significantly smaller in volume than CEM would be. Similarly QBRM, more complex than CEM because it requires counting each piece, poses no complexity problem for witness Miller.

Witness Miller argued also that the implementation of CEM would require the Postal Service to have more stamps printed. He was unable to explain, however, what the cost of this printing would be or even how many extra stamps would need to be printed. His argument is invalid when one takes account of the fact that CEM stamps would replace some of the single piece First-Class stamps. In addition, Miller argues that customers would have to make more trips to the Post Office if CEM were implemented. He could not quantify the cost of these trips nor could he explain why customers would have to do so. Tr. 45/19799.

Q It says that some single piece mail users will have to make more frequent trips to their preferred stamp distribution outlet. Who is going to compel these folks to make more frequent trips or go to a different outlet?

A I don't think anyone would force them to.

The so-called two-stamp problem invented by the Postal Service for Docket No. R97-1 has reemerged. Witness O'Hara attempts to use survey data from Docket No. R97-1 to show that consumers do not want two stamps. Tr. 46E/22020-21. Unfortunately witness O'Hara appears not to have read the Docket No. R97-1 opinion.

In the next set of questions, Ellard says about three-fifths of the population say they are "very likely" (38 percent) or "somewhat likely" (23 percent) to use two denominations for bill paying, while a third (37 percent) say they are "unlikely" to do so. Thus, instead of definitive rejection, the survey appears to show that a majority of consumers reacted favorably to the CEM concept.

PRC Op. Docket No. R97-1 at 323 (citation omitted).

As if the dreaded two-stamp problem is not enough, witness Miller gives us the dreaded two-mailstream problem. Tr. 45/19662. Witness Miller would have us believe that the Postal Service's mail processing operations would be so disrupted by the introduction of CEM that it could barely function. When cross examined on this subject, however, he revealed quite a different picture.

COMMISSIONER GOLDWAY: I'm sorry to extend this, but I did have a few questions. As I understand it from the discussion you had with regard to E-Stamp and Stamps.com, that it's difficult to sort out the mail that is presented in that format from the regular stream of mail that's processed through the machines. And it's not easily distinguished from other mail, therefore, the cost savings are hard to measure and justify. So there's, as I understand the discussion that went on through most of the morning, there is one mail stream, and it is not easy to distinguish the mail. Yet as soon as we started talking about CEM mail, suddenly there were two mail streams, and it was very easy to distinguish between the different kinds of mail that you would see in a mail stream and you would be able to be concerned about different postage. Now, isn't it true that the 20-cent postcard goes through the same mail stream as the 34-cent envelope at this time in your system?

THE WITNESS: That's true.

COMMISSIONER GOLDWAY: So there aren't really two mail streams? This is a concept that you've developed that somehow -- because they would be two kinds of stamps that there would be two different mail streams, but there really aren't two mail streams. That's a word that doesn't make sense in terms of describing how the mail functions. The same mail that has a 55-cent stamp on it, goes through the same stream as the mail that has a 33-cent stamp at the moment, right?

THE WITNESS: [No audible response.]

Tr. 45/19902.

It is clear that witness Miller invented the concept of separate mailstreams in order to create "confusion" about the success of CEM.

(b) The revenue losses associated with CEM (if any) would be trivial compared to the inequity to be remedied

Witness Miller alleges that if CEM were implemented, the Postal Service would spend more administering it than users and the Postal Service would gain. Perhaps the most disingenuous of witness Miller's arguments is the one concerning revenue protection. He alleges that the Postal Service will lose \$300 million annually because of CEM. That is simply the figure calculated by multiplying 10 billion pieces of mail by three cents per piece. He fails to acknowledge that not all of the 10 billion pieces will convert. Even if all 10 billion pieces received the discount there is no loss to the Postal Service. The discount is a recognition that the cost to handle CEM is quite low. Moreover, the OCA has urged a reduction in the requested contingency allowance and proposed other test year expense and revenue adjustments. The Commission can fashion rates that do not endanger the Postal Service's bottom line.

In determining the losses to the Postal Service from underpayment of postage, witness Miller cites a 1999 figure of underpayment of postage as if it were normal for

the underpayment to be 7.35 percent every year. That year included a rate increase. In addition witness Miller's 7.35 percent included additional ounce pieces. The actual percent of short-paid mail of less than one ounce was 0.74 in 1999 and 0.20 in 1998. The 7.35 percent is *ten* times the actual 0.74 percent. Witness Miller went on to assert that the Postal Service would incur nearly \$70 million to collect a little more than \$10 million.

Q Perhaps I am reading the exhibit incorrectly but as I understand it, the number in Column 6 represents the maximum revenue loss that would be incurred at the various percentages of short paid mail. Column 4 represents the enforcement costs that the Postal Service will incur to prevent that maximum revenue loss. Is that correct?

[Pause.]

A Yes.

- Q You'll excuse my puzzlement, I hope. Why would the Postal Service spend almost \$70 million in order to get back a little over \$10 million?
- A I think that is one of our points, that it is not worth spending this money. We'd have to enforce the proper behavior and it is just not financially sound to have to spend this much money for a proposal that even Witness Willette says that most -- well, not most people but some people will not use.
- Q Well, I am still puzzled. If we assume that short paid mail almost doubles so you get 2 percent short paid mail as a result of CEM, the most you would lose, as I understand this, is a little over \$10 million. Why would the Postal Service incur any of these other costs -- revenue clerk costs, postage due costs --
- A Well, I think as I said they would have to reinforce the proper behavior and your question assumes that we know how much mail is going to be short paid from the beginning, which we don't, so we would

Tr. 48/22469. Revised Response of USPS Witness Miller to Question Posed by OCA at Tr. 45/19815 During Hearings (Erratum), Sept. 5, 2000.

spend the money in Column 4 to reinforce proper behavior and the revenue loss is calculated separately in Column 6.

- Q But every number in Column 4 is much greater than the number in Column 6. Why would you spend any of that money when you get back less?
- A I don't think it is an acceptable alternative just to take a revenue loss for consumers using stamps in error. That is another one of our points is that this unnecessarily complicates the system, and it is —
- Q Mr. Miller, the Postal Service is not going to do this, is it?
- A What are you referring to? Spending this money?
- Q Spending \$70 million to get ten, spending \$103 million to get 22. It makes absolutely no financial sense, does it?
- A We agree this proposal makes no sense and the money that it would be required to spend to enforce the proper behavior is not worth realigning the postage costs that are a maximum of \$300 million and less than that given that Witness Willette herself has said not everyone will use it.

Tr. 45/19826-28. What makes no sense is witness Miller's assertion that the Postal Service is willing to spend \$70 million to collect \$10 million.

(c) <u>Deaveraging is preferable to defenestration</u>

Both witness Miller and witness O'Hara raise the specter of deaveraging as an argument against CEM. They claim that small mailers benefit from the current "one rate fits all" approach to single-piece First Class. Obviously, mailers of high-cost pieces benefit from rate averaging. But failure to give CEM its own rate will ultimately prove self-destructive for the Postal Service. And the small mailers who use CEM are almost certainly *not* the source of high-cost mail pieces. High-cost pieces in First Class are flats and parcels, not handwritten one-ounce letters as witness Miller suggests. Tr.

45/19819-20. Thus, to the extent that CEM mailers are also mailers of one-ounce handwritten pieces, they will not suffer as a result of CEM-induced deaveraging.

On the other hand, *all* mailers will suffer if the Postal Service does not recognize CEM as a separate rate category. CEM consists mostly of bill payments. As such, it is susceptible to diversion to Internet bill-paying services. The Postal Service needs to establish a rate category for CEM in anticipation of the time when it will want to offer a significant discount for such mail in order to keep it in the system. While the OCA is only proposing a three-cent discount now, the Postal Service may well be wanting to increase that discount to a level that will allow it to retain some of the contribution to institutional costs it now takes for granted. Such action is certainly preferable to allowing eight to ten billion pieces to migrate to the Internet, taking \$2 billion of contribution with them.¹⁹³

CEM is a simple concept. It has been thoroughly tested on the record of several proceedings. It will offer consumers a choice. The Postal Service exhibits paternalistic behavior in blocking the public's choices. Over a decade into automation, there remains an unacceptably large disparity between rate and cost for CEM. Consumers still lack direct benefits from the billions of dollars - their revenue contribution dollars - spent on automation. This is unfair, inequitable, and discriminatory.

¹⁹³ If each piece of CEM contributes \$0.28, then eight billion pieces would contribute \$2.24 billion.

B. The Single-Piece First-Class Letter Rate Should Be Held Constant over Two Rate Cases

OCA proposes, in the testimony of witness Callow, that the Postal Service adopt a new approach for setting the single-piece First-Class rate for letters that would benefit both household and business mailers. Tr. 22/10128-46. The Postal Service appears to have adopted plans to adjust rates every two years, in response to the concerns of business mailers. However, more frequent rate changes can be inconvenient to household and smaller-volume mailers. The approach proposed by OCA would accommodate these differing interests by providing a longer period of stable rates for household mailers and permit smaller, more frequent rate changes for business mailers.

 Adjusting the single-piece First-Class Letter rate every other rate case would accommodate the differing interests of household and business mailers

Witness Callow proposes that the single-piece First-Class ("SPFC") rate for letters be adjusted every other rate proceeding. As proposed by witness Callow, the single-piece rate would be determined without regard to the "integer constraint" in each rate proceeding. The rate paid by households and other single-piece mailers, however, would be set at a whole cent, as in the past. The determination of First-Class rates other than single-piece would be based on the "calculated non-integer rate" in each proceeding. Tr. 22/10136.

In effect, the SPFC integer rate would be set so that sufficient revenues would accumulate in an "SPFC Reserve Account" during the first rate period to permit the single-piece rate to remain the same during the period after the second rate

proceeding—a duration of approximately four years, or perhaps longer. Under this approach, household mailers would enjoy greater rate stability, while allowing business mailers smaller, more frequent and predictable rate adjustments.

This approach is particularly beneficial given Postal Service plans to initiate rate proceedings on a more frequent and regular basis, in response to the desires of business mailers. There is considerable evidence in this record that the Postal Service is planning future rate adjustments on a more frequent and predictable basis—approximately every two years. Tr. 22/10132-33. In particular, Deputy Postmaster General John Nolan makes clear that postal management is beginning to plan for the 2003 and 2005 rate cases. *Id.*

Postal management has stated its objective "is to extend the rate cycle for as long as possible in concert with the Board's policy on equity restoration." Tr. 46C/20904. While this is the Postal Service's position for rate case purposes, it is evident that the Postal Service has adopted a real world plan to work with mailers such that new postal rates will be in effect for a period of approximately two years. Tr. 22/9829.

It is important to emphasis that the rate stability proposal is not intended to shift costs between mail classes or otherwise adversely affect larger mailers. Tr. 22/10233. Witness Callow also demonstrates that it is possible to accommodate the differing interests of household and business mailers while preserving Postal management's prerogatives with respect to rate changes. As proposed, the proposal would also preserve the right of every participant to litigate any issue in every case. Tr. 22/10186-

- 87. The only difference is that revenues generated in the first rate case period would permit the single-piece First-Class rate to remain in effect over two rate cases.
 - 2. The single-piece First-Class rate proposal will have modest effects on single-piece and workshare volumes

Changing the SPFC rate every other rate proceeding while rates for workshare mail change each rate case will cause volumes to shift between single-piece and workshare. By holding the SPFC integer rate constant through two rate cases, as proposed by witness Callow, the workshare discount "cycles" up and down compared to the SPFC rate with each rate case (although the amount of the discount relative to the calculated single-piece rate is assumed not to change). In the first rate case, when the SPFC rate is greater than the calculated single-piece rate, there is a larger workshare discount. In theory, this should generate more workshare mail. The opposite effect results when the SPFC rate is less than the calculated single-piece rate after the second rate case, creating a smaller discount relative to the SPFC rate. Tr. 22/10136-37.

The shifting of volumes to and from single-piece and workshare could become larger especially in a period of high or rising inflation. This, in turn, could cause the workshare discount to shrink even more compared to the SPFC rate, reducing workshare volume even more. Such an outcome could create difficulties for presort and pre-barcode mailers. Moreover, holding the SPFC rate constant for a period of two rate cases creates the risk that sufficient revenues may not be generated in the SPFC Reserve Account to cover the likely revenue deficiency during the second rate case period. Tr. 22/10143-44.

In order to minimize such difficulties (and ensure that sufficient revenues are available to sustain the SPFC rate) during the second rate case period, witness Callow recognizes that the SPFC rate may need to be increased in two consecutive rate cases. As a result, witness Callow proposes that in circumstances where the calculated single-piece rate in the second rate case is expected to increase by more than 1.5 cents above the existing SPFC integer rate, a change in SPFC rate would be warranted. If changes in the calculated single-piece rate were limited to 1.5 cents, there would be less likelihood of a large deficit in the SPFC Reserve Account, and the volume shift between single-piece and workshare mail would be limited. *Id*.

The possibility of a large deficit in the SPFC Reserve Account in the second rate case period suggests the need to analyze costs, prior to selection of the SPFC rate, during the entire period in which the SPFC rate would be in effect. Tr. 22/10256. Projections of costs, growth in First-Class revenues and volumes, inflation, and change in the balance in the SPFC Reserve Account during the second rate case period would be relevant, but not necessary, at the time of the first rate proceeding. Tr. 22/10282. In the context of the rate stability proposal, setting the SPFC rate does not have to be a precise exercise, as the SPFC Reserve Account is intended to serve as a "buffer" that would absorb changes in revenue caused by holding the SPFC integer rate constant over two rate case periods. As a result, revenue generated in the first rate case period would offset partially an unforeseen larger deficiency during the second rate case period. This is similar to the current situation where revenues are not being generated sufficient to fund current operations, prompting the Postal Service to initiate a new rate request. Tr. 22/10284.

 The adjustment of single-piece First-Class rates every other rate proceeding requires a change in Postal Service policy, not a change in law

The success, or lack thereof, of the rate stability proposal is dependent upon postal management. No change in law is necessary. Postal management must simply decide whether a longer period of rate stability for single-piece mailers is a policy it should adopt. Under the rate stability proposal, postal management is able to file omnibus rate proceedings, and to select the implementation date of rate changes, at its discretion. Tr. 22/10187.

Moreover, the SPFC Reserve Account could be established at the direction of postal management. Tr. 22/10190. Such an account would not have to be established as a segregated trust or similar fund. Rather, the SPFC Reserve Account could be treated in the same manner as RPYL, which was created by the Postal Service, and its operation shown in the Statement of Revenue and Expense. With respect to RPYL in the test year, additional money is collected and included in "Operating Revenue," and is used pursuant to management policy for RPYL.

The same is proposed for the SPFC Reserve Account. Additional revenues would be collected for the rate stability proposal, with the same amount of revenues reported in a new line entitled "SPFC Reserve Account" in the Statement of Revenue and Expense. Any additional revenues collected would be used pursuant to management policy to maintain the SPFC rate in the second rate case period.

Finally, as the testimony of witness Callow reveals, rate stability for single-piece First Class mailers can be achieved in two ways. If the Commission maintains the current First-Class rate at 33 cents, rate stability will effectively be provided through two

rate case periods, Docket Nos. R97-1 and 2000-1. Tr. 22/10246. This would also reduce the high institutional cost burden on First-Class Letter Mail. The preferred option of the OCA is that the high institutional cost burden on First-Class Letter Mail be reduced, whether or not the Commission decides to recommend the SPFC rate stability proposal. Tr. 22/10284. If the 33-cent single-piece rate is retained, the rate stability proposal could be studied further and addressed formally in the next rate proceeding.

C. The Nonstandard Surcharge Should Be Eliminated for Low Aspect Ratio Mail

The Postal Service's proposed (and current) 11 cent surcharge should be eliminated for single-piece First-Class "low aspect ratio" letter mail—letter-shaped mailpieces that are square or nearly square in shape. Tr. 22/10147. The testimony of OCA witness Callow demonstrates that the nonstandard surcharge is no longer warranted for such mail. Tr. 22/10147-67.

The Postal Service's justification of the surcharge for single-piece low aspect ratio letter mail is problematic. Through the testimony of witness Miller, the Postal Service fails to substantively address Commission concerns as to the continued relevance of the surcharge for low aspect ratio letters. Moreover, it is clear from the evidence in this proceeding that low aspect ratio letters are being routinely processed and sorted to carrier walk sequence on automation. As a result, witness Miller's assumption that all nonstandard letter mail is manually processed, an assumption which underlies the costing on which the surcharge is based, is invalid.

Witness Callow presents more realistic assumptions as to the processing of low aspect ratio letter mail that reveal costs less than the surcharge. These lower costs,

and the small amount of extra revenue associated with the surcharge on low aspect ratio letter mail, justify eliminating the nonstandard surcharge. Moreover, eliminating the surcharge for such mail would enhance fairness and equity for individual mailers.

 Commission concerns from Docket No. R97-1 with respect to the nonstandard surcharge have not been addressed by the Postal Service

In Docket No. R97-1, the Commission rejected the Postal Service's proposed increase in the nonstandard surcharge for single-piece and presort mail. In doing so, the Commission found "compelling reasons" for maintaining the surcharge for single-piece mail and presort mail at 11 cents and 5 cents, respectively. PRC Op. R97-1, ¶5226. The Commission determined, however, that a "comprehensive review" of the nonstandard surcharge was warranted to address criticisms raised during that proceeding. *Id.* In this proceeding, no comprehensive review has been undertaken by the Postal Service to address such criticisms, highlighted by the Commission's R97-1 Opinion.

(a) No new information or data has been presented by the Postal Service to address Commission concerns

The stated purpose of witness Miller's testimony is to address three issues that drew criticism in Docket No. R97-1: the validity of the nonstandard letter definition, the assumption of 100 percent manual processing for nonstandard letters, and cost data for mailpieces weighing less than one ounce. USPS-T-24 at 19. Unfortunately, witness Miller's testimony does not rise to the level of a comprehensive review requested by the Commission. Nor does his testimony address the criticisms in any substantive way.

The Postal Service fails to provide an analysis of mail processing operations or any new information or data to justify the nonstandard surcharge for low aspect ratio letters. According to witness Miller, with respect to the definition of nonstandard mail, the Postal Service has not reevaluated the requirements relating to aspect ratio since they were established in Docket No. MC73-1. Tr. 45/19838-39; see also Tr. 7/3222.

In this proceeding, witness Miller assumes, as was the case in Docket No. R97-1, that "all nonstandard letters are processed manually." USPS-T-24 at 22. In Docket No. R97-1, the Commission questioned that same assumption, among others. PRC Op. R97-1, ¶5228.

The manual processing assumption is questionable because it is not grounded in the reality of Postal Service mail processing operations. In Docket No. R97-1, the Commission suggested that "if the Service intends to continue to assess these surcharges in the future, it should provide a justification that accurately depicts the current mail processing environment." PRC Op. R97-1, ¶5230. In this proceeding, witness Miller admits that the Postal Service does not "fully understand" how the aspect ratio affects mail processing operations. USPS-T24 at 21-22. More specifically, the Postal Service's understanding is limited by a lack of basic information, such as the proportion of mailpieces that are nonstandard by virtue of an aspect ratio less than 1:1.3. Tr. 7/3132. Additionally, the Postal Service has not conducted any studies that "address aspect ratios and how they might, or might not, 'tumble' on postal mail processing equipment." *Id.* Nor has it attempted to determine how letters with nonstandard aspect ratios are processed through the entire postal network. USPS-T-24 at 21.

With respect to CRA cost data for mailpieces weighing less than one ounce, no new cost data is used in developing costs for nonstandard mail. Witness Miller uses, as he did in Docket No. R97-1, average mail processing unit costs. In Docket No. R97-1, the Commission found such cost support, and a supplemental analysis, "defective." PRC Op. R97-1, ¶5228. Similarly, in this proceeding, witness Miller rejects the testimony of witness Daniels (USPS-T-28), which estimated mail processing unit costs for letters, flats, and parcels weighing less than one ounce, claiming that "it may be difficult to precisely estimate CRA mail processing costs by both ounce increment and shape for low volume categories such as nonstandard First-Class Mail pieces." USPS-T-24 at 22. In other words, witness Daniel's cost data by shape do not look reasonable for one-ounce pieces. Tr. 22/10154.

(b) The Postal Service has no intention of studying the nonstandard surcharge to address Commission concerns

According to witness Miller, the Postal Service has no intention of studying mail processing operations involving low aspect ratio mail. Rather, witness Miller simply provides excuses in an effort to justify the Postal Service's limited understanding of the processing of low aspect ratio letter mail. To wit, "data would be very difficult to obtain in a 'real world' environment due to the fact that the volume of nonstandard letters is quite small and nonstandard letters are mixed with other letters as they move through the postal mail processing network." Furthermore, he asserts that "[i]t is not likely that

Tr. 7/3132. Unstated by the Postal Service is the fact that a better understanding of how various processing equipment might handle low aspect ratio letter mail could be obtained by running controlled tests on selected equipment.

the benefits obtained from such a study [of letters with nonstandard aspect ratios] would outweigh the costs." USPS-T-24 at 22. It is clear such excuses reveal that the revenue and cost associated with low aspect ratio letters are so small that the Postal Service is essentially unconcerned with what (if any) surcharge should be imposed on such mail. Tr. 22/10156. Moreover, such excuses do not address the criticisms related to the justification of the nonstandard surcharge for low aspect ratio letter mail.

2. Low aspect ratio letter mail is being processed on automated equipment and delivered by the Postal service

The evidence in this proceeding supports the conclusion that low aspect ratio letter mail is being processed successfully on automated equipment, at least to some extent. Mail processing begins with the Advanced Facer Canceller System ("AFCS") operation, and continues through several additional processing operations. The presence of certain markings, and lack of others, on low aspect ratio letters indicate such letters have been processed through the entire postal processing network and delivered. In the case of some operations, the probability of success can be estimated.

(a) Theoretically, the Advanced Facer Canceller System will process at least 50 percent of low aspect ratio letter mail

Nonstandard mailpieces are determined to be nonstandard by reference to several physical characteristics. The Advanced Facer Canceller System is specifically designed to remove or "cull" from the mailstream letter mail exceeding the thickness, height, and length requirements that define "standard" mail. Tr. 5/2077-78. However, unlike letters exceeding the maximum thickness, height and length standards, letters

with a low aspect ratio cannot be culled by the AFCS based upon this characteristic.

Tr. 5/2078.

Nevertheless, the AFCS may still remove low aspect ratio letters when they lose their "orientation;" that is, the mailpiece is not properly positioned or "faced" for canceling. USPS-T-24 at 20. In the case of standard-size mail, a mailpiece is properly oriented when the stamp or other indicia is located on the bottom of the long edge as the mailpiece moves through the AFCS. Tr. 5/2080. A detector looks for the stamp along the bottom at the leading edge on one side, or the trailing edge on the other side. Tr. 5/2082. If the stamp is in either position, the mailpiece is cancelled. If the detector does not find the stamp on either side, the mailpiece is flipped. Tr. 5/2080. detector again looks for the stamp on the leading edge or the trailing edge. In the case of a square (or low aspect ratio) mailpiece, there is no long edge. As a result, the stamp may be on the bottom—but in the wrong corner. The stamp could be at the leading edge instead of the trailing edge, or the trailing edge instead of the leading edge. That is, on two out of the four edges on the mailpiece, the stamp could be oriented 90 degrees from where the stamp should be detected. Thus, in two out of four cases (e.g., 50 percent), a square letter may not be "faced" correctly so that the AFCS can locate the stamps, meter marks or other indicia to permit cancellation.

Because the Postal Service has not studied the processing of low aspect ratio mail, the true statistical probability of such letters being successfully cancelled (or conversely, losing their orientation) on the AFCS is unknown. Tr. 7/3225. However, the probability of low aspect ratio mail pieces losing their orientation on the AFCS has been

estimated at 50 percent.¹⁹⁵ Theoretically, at least, there is a 50 percent probability of square letters being presented for further automated mail processing after the AFCS operation. Tr. 22/10156.

(b) The presence of a barcode, and absence of a "Postage Due" marking, means low aspect ratio letters are being processed and delivered through the entire Postal Service network

Nonstandard mailpieces that are cancelled during the AFCS operation can be "successfully processed on one or more operations." USPS-T-24 at 21. With respect to low aspect ratio letters, it is clear that additional processing occurs at least through what is known as the "outgoing primary" operation. Tr. 7/3225. According to witness Miller, "the presence of a barcode on a delivered nonstandard letter shows that this letter has been successfully processed on either the Optical Character Reader (OCR) or the Output Sub System (OSS)." USPS-T-24, at 21.

In addition, it is known that some low aspect ratio letters are processed through the entire automated mail processing network of the Postal Service, and delivered. In Docket No. R97-1, NDMS witness Haldi conducted a "small-scale" experiment in which 10 seasonal greeting cards square in shape (aspect ratio 1:1) were mailed. Of these 10, nine were received with cancellation and barcodes, which evidenced automated

Tr. 5/2082. Witness Miller, however, maintains that "the assumption that a mail piece would be successfully faced 50% of the time on the AFCS was overly simplistic." Tr. 45/19681 [citation omitted]. It should be noted that, first, the 50 percent estimate is based upon the testimony of Postal Service engineering witness Kingsley. Second, the Postal Service does not know, and has no intention to obtain a better estimate of, the percentage of time low aspect ratio letters are successfully faced. Third, it would appear that, once a low aspect ratio letter is successfully faced and cancelled, it will be sorted to the proper bin for further automated processing—even if it tumbles before arriving at that bin.

¹⁹⁶ See Docket No. R97-1, Tr. 24/12884-85.

processing. More importantly, none were marked "Postage Due." The absence of any postage due markings can only mean that these mailpieces were not separated from the automated processing mailstream for manual sortation.

3. Witness Miller's assumption that all nonstandard letter-shaped mail is processed manually is not justified for low aspect ratio letter mail

In this proceeding, witness Miller maintains the fiction from Docket No. R97-1 that "all nonstandard letters are processed manually." USPS-T-24, at 22 (emphasis added). Witness Miller's own testimony contradicts this assumption. The result is costs for low aspect ratio letter mail that are unrealistic and unreliable.

(a) The assumption of all manual processing is not supported by the evidence in this proceeding

As discussed above, the small-scale experiment of witness Haldi in Docket No. R97-1 shows that low aspect ratio letter-shaped mailpieces can be processed partially, if not entirely, through the Postal Service's network of automated equipment, and delivered. Moreover, the assumption that 100 percent of nonstandard letter-shaped mail is manually processed is not supported by the testimony of witness Miller. Witness Miller confirms that the assumption of all manual processing of nonstandard letter mail "is not always true of letters with nonstandard aspect ratios." USPS-T-24 at 23.

(b) The assumption of all manual processing results in costs for low aspect ratio letter mail that should not be relied upon

The assumption that all nonstandard letter-shaped letter mail is manually processed is unrealistic. This assumption, when used in the Postal Service's mail

processing cost model, produces a mail processing unit cost that should not be relied upon for low aspect ratio letters.

Witness Miller develops a unit cost for nonstandard letter mail using the "First-Class Manual Nonstandard Single-Piece" mail flow model. Consistent with his assumption of 100 percent manual processing, witness Miller enters all 10,000 mailpieces at the "Outgoing Primary Manual" operation. USPS-T-24, Appendix I, at I-35. In so doing, witness Miller does not recognize any degree of automated processing for low aspect ratio letter mail.

Witness Miller trivializes the effect of the 100 percent manual processing assumption, maintaining that it has little impact on the *total* cost to process all nonstandard single-piece First-Class mailpieces, since most nonstandard mailpieces are overwhelmingly flat-shaped. USPS-T-24 at 22. However, the assumption can significantly affect unit costs for low aspect ratio letters. The Postal Service's model mail processing unit cost, where 100 percent manual processing is assumed, is 23.941 cents—representing an additional cost of processing such letters of 11.654 cents (23.941 - 12.296). As discussed below, using more realistic assumptions results in more realistic (and lower) unit costs for low aspect ratio letter mail.

 Elimination of the nonstandard surcharge for low aspect ratio letter mail, as proposed by OCA, promotes fairness and equity for singlepiece mailers

Through the testimony of witness Callow, the OCA proposes elimination of the nonstandard surcharge for low aspect ratio letter mail. Witness Callow adjusts the Postal Service's manual mail processing cost model to account for the automated

processing of low aspect ratio letter mail. Those adjustments produce lower unit costs that are reasonable, and such costs are less than the proposed surcharge. Moreover, witness Callow estimates that the loss in revenue associated with eliminating the nonstandard surcharge for low aspect ratio letter mail is minimal, and doing so would promote fairness and equity.

(a) Witness Callow's adjustments to the Postal Service's manual mail processing cost model reflect more realistic assumptions, and produce more reasonable unit costs

The testimony of witness Callow develops mail processing unit costs based upon several adjustments in the manual cost model that better reflect what is known about the processing of low aspect ratio letter mail. While the true percentage of low aspect ratio letter volume receiving automated processing is unknown, the assumption of all manual processing is known to be wrong. Consequently, witness Callow alters the assumption of all manual processing to assume that 100 percent, 75 percent, and 50 percent of mailpieces are entered at the "Outgoing RCR," the beginning of automated processing in the model. Tr. 22/10160. This results in a range of mail processing unit costs for low aspect ratio letter mail, as shown in Table 17 of witness Callow's testimony. Tr. 22/10161. Moreover, the rates for "acceptance" and "upgrade" used in the manual model are adjusted by multiplying such rates by the probabilities associated with each aspect ratio, developed in Table 16. Tr. 22/10158. The linear progression of probabilities assumed in Table 16 suggests that as letters move away from a square configuration toward an aspect ratio of 1:1.3, there is greater probability such letters will be accepted during mail processing operations utilizing automated equipment. Witness

Miller confirms that such a progression is not unreasonable, stating "[w]e should not expect to find accept rates [on automated equipment] for letters with aspect ratios of 1.299 equal to 0%, while finding accept rates for letters with aspect ratios of 1.300 equal to 100%." Tr. 45/19678.

The range of mail processing unit costs presented in Table 17 for low aspect ratio letter mail reflect more realistic assumptions and are reasonable. Nevertheless, all the unit costs in Table 17 are greater than the average single-piece letter mail processing unit cost of 12.296. Tr. 22/10217. However, the additional cost of processing low aspect ratio letter mail (e.g., the difference between each unit cost shown in Table 17 and 12.296) is less than the proposed 11-cent surcharge. *Id.*

In the case of letters having an aspect ratio of 1:1.3 (*e.g.*, standard-size letter mail) that are processed entirely on automated equipment and acceptance rates are adjusted by 50 percent, the model mail processing unit cost is 12.783 cents. This unit cost is not significantly different from the average test year mail processing unit cost of 12.296 cents, based upon the CRA, presented by witness Miller. Nor is this result unexpected, since letter mail of standard size (*i.e.*, at least 1:1.3) processed entirely on automated equipment should exhibit a model mail processing unit cost somewhat similar to the average CRA unit cost.

In the case of letters that are square in shape, where only 50 percent are presented to automated equipment, the model mail processing unit cost is 21.644 cents. This unit cost figure is less than the Postal Service's model mail processing unit

¹⁹⁷ Attachment USPS-T-24B (revised 3/3/2000).

cost, where 100 percent manual processing is assumed, of 23.941 cents. Moreover, the 21.664 cents model unit cost is only 2.056 cents more than the average test year mail processing unit cost of 19.588 cents for letters weighing less than or equal to 1 ounce. The assumption of 50 percent presented for automated processing clearly represents a "worst case" for the automated processing of square letter mail. As a "worst case," the unit cost figure is only 9.348 cents (21.644 - 12.296) greater than the average single-piece letter mail processing unit cost, but still less than the proposed surcharge.

Selecting a midpoint of 75 percent for initial automated processing and adjusting accept rates to 75 percent of those of the Postal Service results in an "adjusted" manual mail processing unit cost of 18.6 cents. This unit cost figure compares with witness Miller's average test year CRA mail processing unit cost of 12.296, the manual letter mail processing unit cost of 23.941, and the 19.588 cent average test year CRA mail processing unit cost for letter-shaped pieces weighing less than or equal to 1 ounce. The largest cost difference is 6.304 cents (18.6 - 12.296), a far cry from the 11 cent surcharge sought by the Postal Service.

(b) The reduction in revenues associated with eliminating the nonstandard surcharge for low aspect ratio letter mail is minimal

Eliminating the 11 cent nonstandard surcharge for low aspect ratio letter mail would slightly reduce First-Class Mail revenues to the Postal Service. Witness Callow

Attachment USPS-T-24B (revised 3/3/2000).

¹⁹⁹ Tr. 7/3234-35, Attachment USPS-T-24B (revised 4/25/2000).

estimates that there are 62,718,000 nonstandard letter-shaped mailpieces in the test year. Tr. 22/10165. Assuming the 62,718,000 nonstandard letter-shaped mailpieces are all low aspect ratio pieces, witness Callow estimates the reduction in revenues in First-Class Mail to be \$6,899,000. *Id.* However, the actual reduction in revenues should be much less, since low aspect ratio letters that pay the surcharge are unlikely to be 100 percent of the 62,718,000 nonstandard letter-shaped mailpieces.

Moreover, eliminating the nonstandard surcharge for low aspect ratio letter mail is unlikely to increase the volume of such mail entered as single-piece. The Postal Service maintains that "[w]ithout an appropriate surcharge, Postal Service mail processing operations could be adversely affected by large numbers of nonstandard pieces." USPS-T-33 (revised 4-17-00) at 28; see also Tr. 7/4880. In the case of individual mailers, such concerns are not justified. To the extent that individual mailers are unaware of the nonstandard surcharge, they have no incentive to increase the volume of low aspect ratio nonstandard letters entered as collection mail. Tr. 22/10220. Moreover, individuals who unknowingly enter low aspect ratio nonstandard letters may never be informed that such letters are nonstandard, even if the letters are delivered with the marking "Postage Due." 200

(c) Fairness and equity are served by eliminating the nonstandard surcharge for low aspect ratio letter mail

A low aspect ratio is one defining characteristic of nonstandard mail. For singlepiece nonstandard letter mail, such a defining characteristic is no longer warranted as a

²⁰⁰ See Docket No. R97-1, Tr. 24/12885.

basis for the nonstandard surcharge. Removing this defining characteristic of nonstandard mail (and eliminating the surcharge on such mail) from the DMCS would promote fairness and equity for consumers mailing single-piece low aspect ratio letters. Consumers are charged extra for low aspect ratio letter mail that requires little (if any) special processing. Given the huge variance in cost estimates for low aspect ratio letters and the refusal of the Postal Service to conduct a study that could reduce that variance, it is patently unfair to continue to impose an 11 cent surcharge on low aspect ratio letters. For these reasons, the nonstandard surcharge for low aspect ratio letter mail should be eliminated as a matter of fairness of individual mailers.

D. The Postal Service Should Provide Courtesy Make-Up Stamps When First-Class Rates Change

A change in the First-Class letter rate places burdens on the general public. As OCA witness Gerarden pointed out, a change in the basic stamp rate results in a surge of consumers visiting post offices, which in turn results in long lines, shortages of new and make-up stamp denominations, and considerable inconvenience to the public.²⁰¹ Witness Gerarden suggests that the Postal Service take the initiative to ease the burden of adjusting to new rates by providing a nation-wide informational mailing that includes ten courtesy make-up stamps to every delivery address. The Commission should support this initiative and encourage the Postal Service to be proactive in assisting the general public when the First-Class stamp rate changes.²⁰²

²⁰¹ Tr. 29/13592-594 and OCA-LR-I-4.

The OCA, of course, takes the position that the Commission should recommend no change in the basic First-Class stamp rate in this case. Other rate changes that affect the general public are not of such (continued on next page)

The average household sends approximately twelve pieces of single-piece First-Class Mail monthly. Tr. 29/13573. Providing ten courtesy make-up stamps would significantly enlarge the time in which consumers can purchase new denomination stamps, and thereby reduce the surge of customers at post offices just before and after the rate changeover date. The hassle of the rate change would be significantly reduced. At the same time, the Postal Service would benefit from positive public relations and would better manage the flow of customers at postal facilities. Tr. 29/13574.

The cost to the Postal Service of this outreach would be modest and potentially could be entirely offset by transaction cost savings. The Postal Service is already seriously considering a nation-wide informational mailing when First-Class rates next change.²⁰³ The additional cost of a mailing that would include ten courtesy make-up stamps, including the revenue foregone, is estimated to be \$16.0 million.²⁰⁴ But provision of courtesy make-up stamps would reduce the number of window transactions, as many consumers would be able to avoid an extra visit to their post office and, instead, could purchase new denomination stamps when they would next purchase stamps in any event. If 30 percent of households and businesses were thereby able to avoid an extra stamp purchase transaction, the Postal Service would

a broad and general character as to call for distribution of courtesy stamps. In the event, however, that the Commission recommends an increase in the First-Class stamp rate in this proceeding, then the OCA urges the Commission to encourage the Postal Service to adopt the OCA's suggested consumer outreach.

²⁰³ Tr. 29/13575; Tr. 21/9082.

Tr. 29/13575-578; see also Tr. 21/9005, 9068, 9069, and 9103.

save \$17.9 million in window sales costs.²⁰⁵ This degree of savings would entirely offset the additional cost of providing the courtesy make-up stamps. Tr. 29/13580.

The Postal Service did not oppose the courtesy make-up stamp proposal in rebuttal evidence. Instead, the Postal Service limited itself to questions about how the proposal might work and implied that the Postal Service could do a better job of informing the public and making the next transition to new stamp rates less painful.²⁰⁶

Of course, any improvement in public education or the transition process is welcome. Tr. 29/13626. To avoid a repeat of the "stamp-ede" of 1999 (Tr. 29/13594), however, the Postal Service should induce beneficial change in the stamp-buying behavior of the public at the time of the next stamp rate change. Only the distribution of courtesy make-up stamps will significantly reduce the costly and inefficient surge of stamp buying in the days immediately preceding and following the change in the stamp rate. As witness Gerarden pointed out, the OCA proposal is designed to bring about a win-win result—convenience for postal patrons fairly balanced by savings in transaction costs for the Postal Service. The Commission should suggest that the Postal Service adopt the OCA courtesy make-up stamp proposal.

The Postal Service calculates that it costs \$0.4596 to make a single component stamp sale at a window. Tr. 21/9121; see also Tr. 29/13579. When customers purchase a small number of make-up stamps of one cent value each, the Postal Service clearly loses money in such transactions.

The impact of window service costs are of great concern to the Postal Service. The OCA notes that fear of increased window service costs is one reason given by the Postal Service in support of its adamant opposition to the OCA's CEM proposal. Tr. 45/19657.

See, e.g., Tr. 29/13598, 13600-605, and 13624-628.

As witness Gerarden noted, the choice of ten courtesy make-up stamps "was intended to balance the benefit to the public with the cost to the Postal Service" and "to encourage stamp purchasing behavior (continued on next page)

VIII. THE COMMISSION SHOULD REDUCE MONEY ORDER FEES AND INSURANCE RATES

A. The Fee for Domestic Money Orders Should Be Reduced

USPS witness Mayo proposes to increase the domestic money order fee from \$0.80 to \$0.90, a 13 percent increase. The 13 percent increase results in a domestic money order cost coverage of 198 percent based upon total money order revenue. If the Postal Service's incremental costs are included with the volume variable costs, the cost coverage ratio drops to 142 percent. Tr. 29/14187.

In Docket No. R97-1, the Commission recommended a 147 percent cost coverage. The Commission noted that even though it lowered the Postal Service's requested 203 percent cost coverage to 147 percent, the recommended cost coverage was close to the system-wide average. Further the Commission noted that "[a] low cost coverage [was] appropriate for a service relied upon by consumers with modest incomes."

OCA witness Collins notes that the Commission has long held the view that money orders should be priced such that the service's cost coverage is considerably lower than the system-wide average. Tr. 29/14192. USPS witness Mayo concedes that "money orders are used by individuals with modest incomes." Tr. 39/17668. Consequently, OCA witness Collins proposes that the domestic money order fee be lowered to \$0.75. In proposing a \$0.75 fee, witness Collins is recommending a cost

by the public that would provide the Postal Service with offsetting cost savings from reduced window transactions." Tr. 29/13619.

²⁰⁸ PRC Op. R97-1, ¶6007. See also Tr. 39/17742.

coverage of 123 percent (Tr. 29/14193) – a coverage more in line with the historical practice of a lower cost coverage for money order fees while still providing a significant contribution to institutional costs.

USPS Witness Mayo attempts to bolster her argument for a higher money order fee by asking the Commission to consider a "ninth criterion" – her assertion that recently more affluent customers are also purchasing money orders. USPS-T-39 at 78. Witness Mayo's attempt to justify increasing the money order fee to \$0.90 simply because some more affluent customers may now use money orders to pay for Internet purchases must be rejected. Tr. 39/17668-69. In general, the more affluent have many resources available to facilitate purchase payments. Some examples of alternative resources are personal checks, credit cards, debit cards, electronic fund transfers and cashier checks. The more affluent purchaser generally wants and is willing to pay for speed and convenience. As a consequence, the affluent purchaser is less likely to make a special trip to the Postal Service to purchase a USPS money order. Except in limited situations such as payment for certain Internet purchases, the more affluent are more likely to make payments with one of the alternative resources previously mentioned.

That some affluent customers make use of money orders does not mean that the importance of money orders to the less affluent can be ignored. For those on limited budgets and having fewer alternative methods of payment available, USPS money orders continue to be an important means of safely transferring funds from one part of the country or world to another.

As noted by USPS witness Mayo and as indicated in OCA witness Collins' testimony, however, the Postal Service is not the sole money order vendor. For example, consider American Express and Travelers Express, which respectively have 31 percent and 28 percent of the market share for money orders, compared with the Postal Service's 27 percent.²⁰⁹ Moreover, money order customers have several vendors to chose from, such as drugstores, convenience stores, Western Union outlets, and retail outlets such as liquor stores. These vendors generally sell money orders at prices below the fee for USPS money orders.²¹⁰ Witness Collins points out that "if the Postal Service wants to be a major competitor in the future for money orders, it should be aware of the challenges the competitors pose." Tr. 29/14191. Consequently, more competition must also be taken into consideration when money order fees are established.

Witness Mayo also argues that her money order fee increase is justified because it is the same rate that was charged for a \$50.00 money order in 1976. Tr. 39/17669. Her argument is baseless. Rates are based upon costs, not decades-old rates. A money order fee, or any fee for that matter, cannot be justified on the grounds that it is the same rate used 24 years ago. Using this illogical approach, the 24 year old 13-cent First-Class letter rate could be revived simply because it once existed.

In addition to recommending a reduction in the fee for money orders, OCA witness Collins also recommends that the Postal Service establish an electronic money

²⁰⁹ Tr. 14/5607; see also Tr. 29/14190-191.

Internet companies. Tr. 29/14195. The Postal Service could become a major player in the new market for money orders, which is being driven by Internet sales. Tr. 29/14194. Witness Collins notes that electronic money orders can function as a convenient and secure means for purchasing goods. *Id*.

B. The APO/FPO Money Order Fee Should Be Reduced

USPS witness Mayo recommends increasing the APO/FPO money order fee from \$0.30 to \$0.35, a 17 percent increase. Witness Mayo's logic for doing so is based upon a seriously flawed understanding of APO/FPO money order fee eligibility. As a consequence and at a minimum, the \$0.30 money order fee should be retained. However, OCA witness Collins provides support for a \$0.25 fee – a 5-cent fee reduction.

USPS witness Mayo misunderstands APO/FPO Money Order Fee eligibility

The DMM Issue 55, R900.13.0 (b), states, the "Domestic money order fee issued at other post offices, including those with branches or stations on military installations): [is] \$0.80." USPS witness Mayo's argument that the high value of the USPS postal money order to *domestically* stationed personnel justifies raising the money order fee for APO/FPO addresses is fatally flawed. The 30-cent rate simply is not available to such personnel. Witness Mayo claims that "Postal money orders should actually be of

Tr. 29/14191. Witness Mayo acknowledged that many private money order vendors are price-competitive. Tr. 14/4498.

an extremely high value to domestically-stationed military personnel away from their own financial institutions due to the abundance of post offices throughout the United States and its territories." Tr. 39/17670.

DMM Issue 55, R900.13.0 (a) states the "Postal military money order fee (issued by military facilities authorized by the Department of Defense): [is] \$0.30." APO/FPO addresses are assigned to offshore, remote, or overseas duty stations for the purpose of maintaining the security of the United States and its personnel. Thus, personnel assigned to an APO/FPO location do not have "the abundance of post offices" available to domestically stationed personnel, nor the luxury of searching for alternative methods of safely transferring money home. In offshore, remote, and overseas duty stations, postal money orders are frequently the only money orders available to military personnel and, thus, the Postal Service effectively operates as a monopoly.

2. Failure to comprehend eligibility does not justify the money order fee rate increase

Witness Mayo failed to justify her proposed rate increase. At a minimum, the current \$0.30 fee should be maintained. However, OCA witness Collins notes that USPS witness Mayo is proposing a fairly high money order fee cost coverage (142 percent). As noted by witness Mayo, test year APO/FPO money orders are anticipated to generate \$327,000, 0.1 percent, of the total \$305.5 million in money order revenues.

Tr. 39/17748. Moreover, military personnel, not postal employees, issue and redeem2 postal money orders at APO/FPO locations.²¹¹

OCA witness Collins requests that the Commission lower the APO/FPO money order fee to \$0.25. The rationale behind the fee reduction is that the Postal Service has an effective monopoly on money orders available to U.S. military personnel serving at APO/FPO locations. Contrary to witness Mayo's assertion, *domestically*-stationed military personnel do not qualify for the lower APO/FPO money order fee. During cross-examination, USPS witness Mayo noted that when the Postal Service is dealing with a "public service type issue," a cost coverage that is somewhat lower than it might otherwise be is acceptable. Tr. 39/17743. Certainly, U.S. military personnel assigned to APO/FPO locations are providing a significant service to their country. Therefore, the Commission has the opportunity and is certainly justified in lowering the APO/FPO money order fee.

- C. The Postal Service Has Failed To Support The Proposed Insurance Fee Increases
 - 1. USPS witness Mayo's fee for unnumbered insurance is based upon erroneous cost information and must be reduced

USPS witness Mayo initially set insurance fees such that the overall cost coverage would be 138 percent. USPS-T-39 at 59. For unnumbered insurance with a value of up to \$50.00, costs are estimated to be \$1.26 by USPS witness Davis. Tr. 39/17726. USPS witness Mayo proposed a \$1.35 rate, resulting in a 107 percent

Tr. 29/14194. Witness Mayo concedes that military personnel sell and redeem money orders at an APO/FPO location. Tr. 14/5602.

unnumbered insurance fee cost coverage. *Id.* This represents a very significant rate increase from the existing \$0.85 rate – a 59 percent jump. However, USPS witness Davis filed errata to his testimony indicating that the \$1.26 cost was erroneous; the correct cost for unnumbered insurance is \$0.95. *Id.* Consequently, USPS witness Mayo's rate of \$1.35 is based upon the incorrect cost of \$1.26.

During cross-examination, USPS witness Mayo admitted that in light of USPS witness Davis' acknowledged error, witness Mayo would recommend a fee lower than the proposed \$1.35 fee. Id. However, she would not be willing to "pass-through" the total \$0.31 cost correction. Instead, witness Mayo would limit the correction "passthrough" to \$0.15 and the revised fee proposal would be \$1.20. Id. A rate of \$1.20 results in a fee cost coverage of 126 percent (\$1.20/\$0.95). Witness Mayo justifies limiting the cost correction "pass-through" to less than 50 percent (\$0.15/\$0.31), while increasing the cost coverage by 19 points (126% - 107%). She bases her "passthrough" limitation on her belief that she was originally constrained from proposing a higher rate by a high cost. Tr. 39/17727. However, nothing about the USPS insurance offering has changed: its value to the customer has not increased; the amount of competition has not changed; and the level of service has not improved. What does appear to be happening is that the Postal Service is increasing the price simply because it thinks it can. The Commission should recommend that the rate for unnumbered insurance be set at \$1.05, which would result in a cost coverage of 111 percent.

Docket No. R2000-1

2. Extremely low insurance usage for values exceeding \$900.00 may be due to a high fee relative to a low valued service

The ability to purchase USPS insurance for values in excess of \$600.00 has been available since June 8, 1997. Tr. 39/17736. The Postal Service has had approximately three years to collect data on USPS insurance purchases. The Postal Service has not gathered and analyzed that data however, leaving the Commission without a full understanding of the costs related to higher-valued insurance. In the absence of hard data, USPS witness Mayo implies that three years and low volumes above the original \$600.00 insurance limit justify letting the USPS establish whatever price it feels is justified. Tr. 39/17736-37.

As noted by OCA witness Collins, the Postal Service continues in its failure to provide any credible justification for increasing the incremental fee rate. Tr. 29/14196. As witness Collins points out, in Docket No. MC96-3, the Commission acknowledged that there was lack of support for the incremental fee, and recommended that the Postal Service attempt to accurately determine all cost changes that were related to the change in indemnity limits. Tr. 29/14196-97. Yet, the Postal Service failed to heed the Commission's recommendation. USPS witness Mayo acknowledges that less than 1 percent of the current insurance volume is over \$900.00. Tr. 39/17736. She agrees that she does not know what, if any, differences exist in processing a request to purchase \$50.00 or \$5,000.00 worth of insurance. Tr. 39/17731. Other than the possibility of local adjudication of claims valued up to \$100.00, witness Mayo admits that there is a standard USPS claims process. Tr. 39/17733-34. However, she does not know what if any differences exist in processing insurance claims of \$101.00 to

\$5,000.00. Tr. 39/17734. Her lack of knowledge has a potentially significant impact upon her ability to set competitive rates and may provide some insight into why less than 1 percent of the insurance volume is greater than \$900.00. One hypothesis to consider is that the relatively high price exceeds the public's perceived value of USPS insurance for higher-valued items.

Given USPS witness Mayo's lack of understanding of the costs of purchasing and processing claims for the various denominations of insurance, OCA witness Collins correctly argues that the Postal Service failed to justify an insurance fee rate increase. OCA witness Collins aptly proposes that the Commission maintain the existing \$100 incremental fee of \$0.95. Further, witness Collins recommends that the Commission consider modifying the insurance fee for insured articles valued at over \$1000, and give serious consideration to establishing increments of \$250 or \$500, with an appropriate adjustment in the per increment fee. Tr. 29/14199.

D. The Postal Service Should Make Fee-Free Electronic Delivery Confirmation Available to Individuals for Priority Mail

Delivery Confirmation is a fairly new service offered by the Postal Service. USPS witness Mayo is proposing to increase the current 35-cent manual Delivery Confirmation fee for Priority Mail to \$0.40. While bulk mailers of Priority Mail are eligible to receive electronic delivery confirmation at no additional charge, individual priority mail users are not.

OCA witness Collins states in her testimony that the Postal Service has entered into partnerships with other Internet companies that provide the public with various packaging, mailing, and rate comparison services. Tr. 29/14200. Through Internet

partnership companies, individuals who chose Priority Mail as the method of shipment are eligible to "obtain confirmation of delivery, together with any intervening scan in transit, by visiting the Postal Service's website or the website from which the [mailing] label was downloaded." Tr. 29/14201. One can logically deduce that there is market demand for Priority Mail electronic delivery confirmation by individual consumers.

Unlike bulk mailers, however, individuals cannot obtain the USPS electronic delivery confirmation service for Priority Mail directly; rather, individuals must obtain the electronic delivery confirmation service through a third party vendor. The Postal Service currently permits its Internet partners to make the qualifying electronic Priority Mail labels available to individuals at no charge.²¹² In our fast-paced society, individuals as well as companies recognize that time is a limited commodity and fuel a costly resource. Consequently, any service that saves both resources is commendable. Bulk mailers enjoy the two cost savings because of the Postal Service's electronic delivery confirmation service. Individual mailers who wish to utilize electronic delivery confirmation to save time and decrease fuel consumption, due to a reduction in the number or trips to the post office, should also be given this opportunity by the Postal Service.

The Postal Service is affirmatively searching out opportunities to provide electronic services as adjuncts to traditional mail delivery. Certainly, allowing customers, who have Internet access, the capability to obtain electronic delivery confirmation and then verify "on-line" delivery confirmation is one way to make Priority

²¹² Tr. 29/14199-201 and 14215.

Mail more relevant and desirable. OCA witness Collins appropriately recommends "that the no-charge status for provision of electronic delivery confirmation service to bulk Priority Mail users be extended to individuals." Tr. 29/14201. The Postal Service evidently wants to make its website more useful to individuals and to encourage individuals to access its website more frequently. On the USPS website, making shipping labels with electronic delivery confirmation available to individuals at no charge would be one more way to bring the public to the Postal Service's electronic portal.

IX. THE FEE FOR BULK PARCEL RETURN SERVICE SHOULD NOT BE REDUCED

The current fee for Bulk Parcel Return Service ("BPRS") is \$1.75 per piece. In this proceeding, the Postal Service, through the testimony of witness Mayo, proposes a BPRS fee of \$1.65, resulting in a cost coverage of 146 percent. USPS-T-39 at 15. In the alternative, the Continuity Shippers Association ("CSA"), through the testimony of witness Buc, proposes a much lower fee of \$1.33 per piece. Tr. 23/10643. This fee is based upon both a revised unit cost lower than that estimated by the Postal Service and the same cost coverage as proposed for Standard (A) Regular, resulting in a much lower cost coverage of 132.9 percent. *Id*.

The Commission should reject the fee proposals of both the Postal Service and CSA. Neither the Postal Service's nor CSA's fee proposals, based upon their respective unit costs, reflect the high value of service that BPRS provides to both mailers and recipients. Unlike the proposals of the Postal Service and CSA, the Commission's recommended fee for BPRS should produce a cost coverage at least as high as the systemwide average.

A. The Postal Service's Proposed Fee for Bulk Parcel Return Service Does
Not Produce A Cost Coverage "Close To" the Systemwide Average

Witness Mayo claims that the proposed fee for BPRS was designed to produce a cost coverage "close to, yet below" the systemwide average cost coverage.²¹³ Elsewhere, witness Mayo states that her "major consideration . . . was maintaining a cost coverage close to the systemwide average (Criterion 3), similar to the intention at the inception of the [BPRS] service." USPS-T-39 at 17.

At the inception of BPRS in 1997, the Commission recommended a cost coverage for BPRS of 156 percent,²¹⁴ consistent with the request of the Postal Service.²¹⁵ That cost coverage is very close to the systemwide average of 156.8 percent established in Docket No. R94-1.²¹⁶

Despite the stated importance of this "major consideration," witness Mayo's proposed fee for BPRS results in a cost coverage considerably below the systemwide average in this proceeding. This result is not surprising. At the time witness Mayo developed the proposed fee for BPRS for this docket, the systemwide average cost coverage was unknown to her as it was not "finalized." Consequently, witness

²¹³ USPS-T-39 at 16; see also Tr. 39/17721.

Docket No MC97-4 at 10. "[T]he proposed classification and fee changes meet the criteria of 39 U.S.C. §§ 3622 and 3623, and conform to the policies of the Postal Reorganization Act." In a subsequent review, the Commission declined to adjust the BPRS cost coverage "outside the confines of an omnibus rate proceeding." PRC Op. C99-4 at ii.

²¹⁵ See Docket No. MC97-4, USPS-T-2 (Adra), at 16.

See PRC Op. R94-1, Appendix G, Schedule 1.

Tr. 14/5589. It should be noted that during oral cross-examination on rebuttal, witness Mayo claims she was aware of the systemwide average cost coverage in this proceeding when she developed the proposed fee for BPRS. See Tr. 39/17721. Her oral testimony is inconsistent with her written (continued on next page)

Mayo's effort to design a BPRS fee having a cost coverage "close to" the systemwide average in this proceeding was not possible, with the result that the proposed cost coverage does not square with her stated intention.

The Postal Service's proposed BPRS cost coverage of 146 percent is 22 percentage points below the proposed systemwide average cost coverage of 168 percent.²¹⁸ In fact, the proposed BPRS cost coverage does not even reach the midpoint between the systemwide average cost coverage and the cost coverage proposed by CSA. CSA witness Buc proposes a cost coverage for BPRS of 132.9 percent, the same cost coverage applicable to Standard (A) Regular Mail. The Postal Service's proposed cost coverage for BPRS is therefore only 13 percentage points above the cost coverage proposed by CSA. Tr. 39/17722-23. As is clear, the proposed BPRS cost coverage is closer to the Standard (A) Regular cost coverage than the systemwide average. Tr. 39/17723.

B. The Appropriate Cost Coverage for Bulk Parcel Return Service Should Be Close to the Systemwide Average

The appropriate cost coverage for a mail class or service is determined by pricing, which involves consideration of the policies of the Postal Reorganization Act and nine pricing criteria set forth in Section 3622(b) of the Act. The cost coverage of a class or service, when viewed in relation to the systemwide average cost coverage for

response to OCA/USPS-T39-2(a), which is more contemporaneous in time to the date of her initial proposal for BPRS, and should be considered more credible than her testimony during oral cross-examination.

²¹⁸ See USPS-T32, Exhibit USPS-32B (revised 4-21-00) at 1.

all mail classes and services, should properly reflect the relative value of such a class or service. BPRS should be assigned a cost coverage at least as high as the systemwide average—certainly closer to the systemwide average than the cost coverage proposed by the Postal Service. Indeed, with the recent classification change in Docket No. MC99-4 that further increased the value of the BPRS service, a cost coverage even higher than the systemwide average can be justified for BPRS.²¹⁹

Section 3622(b)(2) of the Act requires consideration of the "value of service" actually provided to mailers and recipients (Criterion 2). There are generally two aspects to value of service—"economic" value and "intrinsic" value. Economic value considers customer perceptions of the value of service, and the availability of alternative services, measured by elasticity of demand. The lower the elasticity of demand, the lower the consumer response to a change in price. Intrinsic value considers the actual service levels and features such as delivery, collection, and transportation. With respect to both aspects of "value of service," BPRS provides a very high value of service to both mailers and recipients. 220

1. The economic value of service for BPRS is very high

The low price elasticity of demand for BPRS reflects its high economic value. In economic terms, the absence of economically realistic alternatives or available substitutes for a product or service suggests a low price elasticity of demand.

Bulk Parcel Return Service Expedited Minor Classification Case, "Opinion and Recommended Decision Approving Stipulation and Agreement," August 19, 1999.

According to witness Buc, "[t]here is no economically realistic alternative to the Postal Service return of BPRS parcels." Tr. 23/10652. In general, a low price elasticity of demand indicates a high value of service. Tr. 23/10667; see also Tr. 14/5368. Consequently, it can be inferred that BPRS has a high value of service.²²¹

2. The intrinsic value of service for BPRS is very high

A number of actual service characteristics of BPRS also reveal a very high intrinsic value. BPRS has served to remove uncertainties associated with the return of products and merchandise, as compared to the period prior to establishment of BPRS. Witness Buc admits that Cosmetique prefers to receive its returns via BPRS for several reasons. Specifically, Cosmetique receives returns directly from customers without going through the Postal Service's Mail Recovery Centers. Tr. 23/10681. Consequently, there is less handling by the Postal Service. *Id.* According to witness Buc, there is "a concern that merchandise may be auctioned or sold if it goes to a Mail Recovery Center." *Id.* In effect, BPRS facilitates the prompt return to inventory of parcels shipped originally as Standard (A) Mail parcels containing valuable products or merchandise. Tr. 23/10684. In so doing, merchandise can be more quickly utilized for subsequent sales.

The Postal Service also concludes that, based upon service characteristics, BPRS provides a fairly high value of service to the companies receiving the return of parcels (Criterion 2)." USPS-T-39 (revised 1-28-00) at 17.

Further support for the high value of service provided by BPRS to mailers using the service can be found in Docket No. C99-4, where a number of issues with respect to value of service were explored in great detail. See, e.g., Docket No. C99-4, Tr. 1/120-27; see also Docket No. C99-4, Initial Brief of the Office of the Consumer Advocate, March 3, 2000, at 16-17.

The intrinsic value of service provided is very high for another reason. Customers can utilize the Postal Service's collection system when returning BPRS parcels. Since BPRS parcels weigh under a pound, they can be deposited anywhere within the Postal Service. Tr. 23/10706. Such a level of service is very convenient—compared to visiting a post office to weigh and pay for the return of a parcel—and is of very high value to customers. Such convenience also increases the likelihood that mailers will recover unwanted merchandise in an expeditious manner. Tr. 39/17647.

3. CSA erroneously claims BPRS has a low value of service

Witness Buc maintains that the "value of the BPRS service is much lower than the value indicated by the Postal Service's proposed cost coverage." Tr. 23/10649. CSA's proposed fee and resulting cost coverage fails to recognize that BPRS exhibits numerous characteristics and economic attributes which make it a service of very high value to both mailers and recipients. Witness Buc discusses a variety of reasons that lead him to this conclusion. Upon closer inspection, his reasoning lacks merit, and the much lower, alternative BPRS fee of \$1.33 per piece proposed by CSA should be rejected out-of-hand.

Witness Buc supports his claim of a low value of service by reference to the low priority for processing, use of ground transportation, and delivery restrictions for BPRS.

Tr. 23/10649. It should be noted that the Postal Service developed BPRS in response to the urging of mailers (including CSA) for an effective and economical bulk parcel

return service.²²² To achieve that end, only ground transportation is used. Moreover, the development of a delivery or pick-up arrangement for BPRS parcels is a cooperative process between the Postal Service and the mailer. Tr. 39/17648; see also Tr. 23/10723. As a result, BPRS mailers may pick-up returns at their option, or have returns delivered by the Postal Service. Rather than a restriction reducing the value of BPRS, the option to pick-up returns provides added flexibility and value to the BPRS service.

Witness Buc attempts to equate BPRS with Bound Printed Matter ("BPM"), for which the Postal Service is proposing a cost coverage of 117.6 percent. Tr. 23/10649. Citing the Commission, witness Buc notes that Bound Printed Matter is used for "bulk national mailings of (among other things) advertising material." Tr. 23/10649-50. As the subclass for the delivery of bulk "heavy weight" advertising material, it is not unreasonable to expect a cost coverage for BPM below the cost coverage for Standard (A) Regular. In addition, the nature of the material eligible for BPM requires consideration of the "educational, cultural, scientific, and informational" ("ECSI") value of the service. See 39 U.S.C. §3622(b)(8). By contrast, BPRS is not intended for bulk advertising mailing, but serves a more select market—product returns.

CSA also contends that the return service provided by BPRS is of lower value to customers than the service when merchandise is originally mailed to customers, at least for Cosmetique. Tr. 23/10650. Thus, it believes the lower value of BPRS warrants a

See Docket No. C97-1, "Complaint of the Advertising Mail Marketing Association Regarding Charges for Standard (A) Merchandise Returns," October 30, 1996. CSA was a signatory to the (continued on next page)

lower cost coverage. However, CSA confuses the value of the merchandise and with the value of the mail service. Common sense suggests that customers might value the BPRS return service even more highly than the original mail service. When customers wish to return merchandise, a reliable return service is essential—for obvious reasons. In the absence of a reliable return service, the customer has neither the use nor enjoyment of the returned merchandise, nor will the customer receive credit for returned merchandise not received by the mailer.

Contrary to the claims of witness Buc, Tr. 23/10650, the recent classification changes recommended by the Commission for BPRS in Docket No. MC99-4 further increased the value of the BPRS service to mailers. Those changes permit the use of return labels at no additional fee and authorize return of opened and resealed parcels without return labels in certain circumstances. The Postal Service maintains that these recent enhancements "could justify a higher cost coverage than the one recommended in Docket No. MC97-4." Tr. 39/17643. At a minimum, it is clear that these classification changes eliminated the "legal uncertainty" with respect to the treatment by the Postal Service of parcels shipped originally as Standard (A) Mail Regular parcels that have been open, resealed, and re-deposited into the mail. Tr. 23/10682.

Also contrary to the testimony of witness Buc,²²³ the educational, scientific, cultural and informational value of BPRS parcels should be a consideration in the

Stipulation and Agreement approved by the Commission in Docket No. MC97-4. See PRC Op. MC97-4, Appendix A.

Witness Buc testifies that pricing criteria 8, relating to educational, cultural, scientific and informational value, does not apply to BPRS. Tr. 23/10653.

pricing of BPRS, consistent with the eighth criterion—albeit a small one. Consistent with his view that BPRS parcels are Standard (A) Mail, witness Buc maintains that considerations of ECSI value should not be applied to material returned using BPRS. However, both the Commission and the Postal Service have determined BPRS to be a special service. As a result, considerations of ECSI are appropriate. While some merchandise returned using BPRS has no ECSI value, other parcels consist of printed material, including books. Still other merchandise returned via BPRS consists of recorded music. See Docket No. MC97-4, USPS-T-2 (Adra), at 4. Considerations of ECSI value should temper a higher cost coverage than might otherwise be warranted for the BPRS service, but certainly do not suggest a cost coverage below the systemwide average.

C. The Current Fee For Bulk Parcel Return Service Produces A Cost Coverage Closer to the Systemwide Average

As discussed previously, the OCA considers a cost coverage for BPRS that is at, or above, the systemwide average cost coverage to be justified.²²⁴ The proposed and alternative fees of both the Postal Service and CSA, based upon their respective unit costs, are inadequate in this regard. The Postal Service's proposed fee of \$1.65 does not produce a cost coverage anywhere "close to" the proposed systemwide average in this proceeding—the stated goal of the Postal Service. CSA's alternative BPRS fee results in a cost coverage far below the systemwide average. However, the current BPRS fee of \$1.75, using the Postal Service's unit costs, does produce a cost coverage

closer to the systemwide average than the proposals of either the Postal Service or CSA.

The Postal Service's proposed fee of \$1.65 and resulting cost coverage of 146 percent is based on a volume variable cost per piece of \$1.13.²²⁵ Assuming the Postal Service's per piece cost of \$1.13, and retaining the current BPRS fee of \$1.75, results in a cost coverage of 155 percent (*e.g.*, 154.9 percent = \$1.75 ÷ \$1.13). Witness Mayo agrees this cost coverage of 155 percent is closer to the systemwide average than the cost coverage of 146 percent she proposes for BPRS. Tr. 39/17723. Nevertheless, 155 percent is still substantially below the systemwide average proposed in this proceeding, and also much below the systemwide average cost coverages recommended by the Commission in Docket Nos. R94-1 and R97-1.²²⁶

D. The Cost Coverage of Standard (A) Regular Is Not Relevant to the Cost Coverage of Bulk Parcel Return Service

CSA witness Buc maintains that the cost coverage for BPRS should be the same as the cost coverage for Standard (A) Regular, proposed by the Postal Service at 132.9 percent in this proceeding. Tr. 23/10649. There is no basis for comparing the cost coverage of Standard (A) Regular to BPRS.

Infra Part C; see also Docket No. C99-4, Initial Brief of the Office of the Consumer Advocate, March 3, 2000, at 11-22.

Tr. 14/5587. CSA witness Buc develops a unit cost for BPRS of 98.9 cents that, based upon his proposed one percent contingency, increases to 99.9 cents. Tr. 23/10643. OCA takes no position as to the appropriate unit cost for BPRS.

The systemwide average cost coverage recommended by the Commission in Docket Nos. R94-1 and R97-1 was 156.8 percent and 155.3 percent, respectively.

BPRS parcels are not Standard (A) Regular. The simple truth is that Standard (A) Regular parcels mailed to customers cannot be returned to the mailer via any subclass of Standard (A) Mail, or at any Standard (A) Mail rate. Nevertheless, witness Buc maintains that because parcels returned under BPRS meet all the requirements of Standard (A) Regular, and are endorsed "Standard Mail (A)" for purposes of processing, such parcels must be considered as Standard (A) Regular when returned. Tr. 23/10650.

Contrary to witness Buc's assertion, Standard (A) Regular and BPRS parcels cannot be considered the same. The reality is that Standard (A) Regular consists almost entirely of unsolicited advertising mail that is either letter or flat-shaped. Tr. 39/17644. Being largely unsolicited, neither the DMCS nor the DMM authorize a service specifically dedicated to the return of Standard (A) Regular letter or flat-shaped mail. This contrasts markedly with Standard (A) Regular parcels, which consist of merchandise solicited by the recipient and may, if authorized by the mailer, be returned using BPRS. In this regard, witness Buc ignores the fact that the BPRS service effectively deaverages the Standard (A) Regular parcel mailstream with respect to the return of such parcels. Parcel shape mail represents only a small subset of Standard (A) Regular. Moreover, Standard (A) Regular parcels that are returned BPRS parcels

According to the Postal Service, "[o]nly 1.6 percent of the Regular subclass is expected to be subject to the Residual Shape Surcharge, which is generally applicable to parcel-shaped merchandise pieces." Tr. 39/17644; USPS-RT-22, footnote 14, at 6. Based upon the most recent (FY1999) annual volume data, Standard (A) Regular parcels total 1,148,035,900 (71,752,247,000 * 0.028). See USPS FY1999 Revenue, Pieces and Weight (RPW) Report.

amount to only a small portion of the total Standard (A) Regular parcel mailstream.²²⁸ As a result, parcels returned using BPRS in no way represent the "average" Standard (A) Regular mailpiece on which the Standard (A) Regular cost coverage is based. It would therefore be wrong to consider the cost coverage of Standard (A) Regular developed to cover all shapes of Standard (A) Regular to be appropriate for BPRS—a service specifically designed to serve only a small subset of parcels that are significantly different in terms of content and shape from that of the overall Standard (A) Regular subclass.

BPRS parcels are different from Standard (A) Regular parcels in another respect. BPRS parcels may be returned by customers one-at-a-time using the Postal Service's collection system. By contrast, access to the collection system is not available for Standard (A) Regular. Standard (A) Regular, by definition, must be prepared and entered in a mailing of at least 200 addressed pieces. DMCS §321.221.

The Postal Service estimates that, based upon the number of known users of the BPRS service, the average annual volume of parcels returned via BPRS total 1,250,060 (24,055 * 52). See USPS "Bulk Parcel Return Service Cost Study," October 29, 1999 (revised 12-21-99), Exhibit A, at 1.

CONCLUSION

The OCA requests that the Commission issue its recommended decision consistent with the discussion of the issues presented in this Initial Brief.

Respectfully submitted,

OFFICE OF THE CONSUMER ADVOCATE

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CERTIFICATE OF SERVICE

I hereby certify that I have this date served the foregoing document upon all participants of record in this proceeding in accordance with Section 12 of the Rules of Practice.

Stephanie S. Ufallace
Stephanie S. Wallace

Washington, D.C. 20268-0001 September 13, 2000